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# STOCK AND BOND BASICS: STARTING AT THE BEGINNING

**T**here are numerous people out there who would like you to believe that investing is complex. Many of them—brokers, financial advisers, “life planners,” and the like—have a vested interest in this; the scarier and more forbidding they can make it seem, the more likely you are to hire them for their advice.

It’s our view that investing is only as complicated or difficult as you allow it to be. So let’s dive right in. We think you’ll be surprised at how simple it really is.

## Stock

Stock is ownership. It’s as basic as that. Buy a share of Microsoft and you acquire a tiny sliver of the software giant. This is ownership in the most literal sense: You get a piece of every desk, contract, and trademark in the place. Better yet, you own a slice of every dollar of profit that comes through the door. The more shares you buy, the bigger your stake becomes.

The stock market itself is basically a daily referendum on the value of the companies trading there. Surely you’ve seen pictures of guys standing around screaming at each other on a stock exchange floor. Their job is to take in the day’s news and distill it down to a single question: Will it help

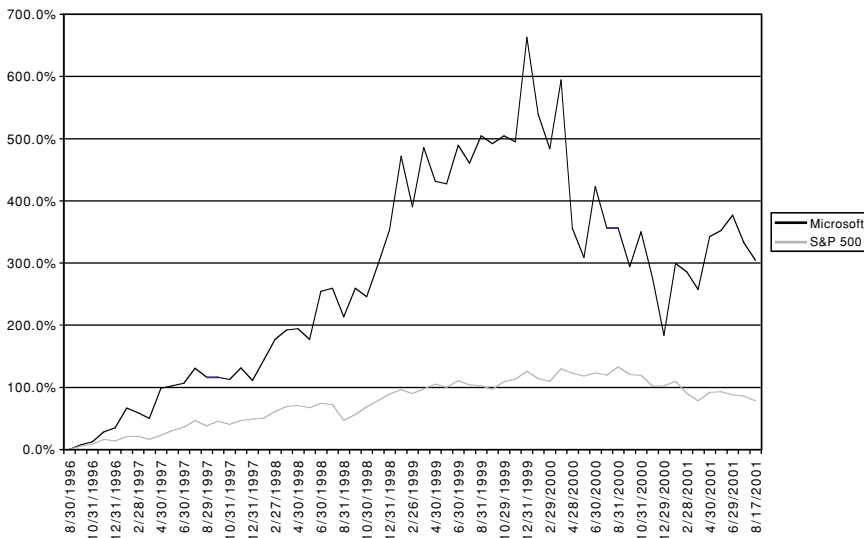
## 6 THE SMARTMONEY STOCK PICKER'S BIBLE

the companies I own make money in the future, or will it prevent them from doing so?

Look at the chart in Figure 1.1. It tracks the price movement of Microsoft stock from 1996 through mid-2001. You can see how it had a tremendous run-up in the late 1990s. Traders felt Microsoft could do no wrong. But then its antitrust case—which came to a head in 2000 when Judge Thomas Penfield Jackson ordered that the company be split in two—helped to send the company's stock spiraling downward. Clearly, traders were no longer so sanguine about its prospects. (Since then, as the decision was overturned, investors came to see the split-up as less likely and bid the stock back up a bit—only to send it back down as the economy sputtered in 2001.)

Whether it's Microsoft or any other stock, the supreme measure by which companies are valued is their earnings (a.k.a. profits). Wall Street is obsessed with them. Companies report their profits four times a year, and investors pore over these numbers—expressed as earnings per share—trying to gauge a company's present health and future potential.

The stock market rewards both fast earnings growth and stable earnings



**FIGURE 1.1** Microsoft vs. S&P 500

growth. But what about a company with a great idea but no immediate prospects for profitability? As Internet investors learned, Wall Street won't tolerate that situation for long. In 2000, the stock prices of many dot-coms went into a free fall as the market reevaluated the worth of these companies. Unfortunately, that left many investors with huge losses.

The market also has little patience for companies with declining earnings or unexplained losses. Bottom line? Companies that surprise Wall Street with bad quarterly reports almost always get punished.

Unlike a bond, which promises a payout at the end of a specified period plus interest along the way, the only assured return from a stock is created if it appreciates on the open market. (While many companies pay shareholders dividends out of their earnings, they are under no obligation to do so.) The worst-case scenario is that a company goes bankrupt and the value of your investment evaporates altogether. Happily, that's rare. More often, a company will run into short-term problems that depress the price of its stock for what seems an agonizingly long period of time.

## Big Stocks

Market capitalization—or market value—is a term you'll come across a lot, so we'll define it right here. It's the number of shares a company has outstanding in the market, multiplied by the share price. If a company has 5 million shares outstanding and each one trades for \$5, its "market cap" would be \$25 million.

As the name suggests, large-capitalization stocks are the biggest players in the market (see Table 1.1). How big? A market value of \$5 billion is generally considered the low end of large-cap stocks, while a behemoth like Microsoft weighs in at more than \$300 billion. Then there's General Electric, the biggest of them all, which toward the end of 2000 temporarily had a market capitalization greater than \$500 billion. Taken together, stocks with market values over \$5 billion account for 82 percent of the market's total \$16.1 trillion in value.

These companies play an especially significant role in driving the economy. That's why everybody pays so much attention to them. The two most-watched indexes—the Dow Jones Industrial Average and the Standard & Poor's 500-stock index—are both composed of large-cap stocks. The Dow tracks 30 of the biggest stocks on the New York Stock

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**TABLE 1.1 THE 10 BIGGEST STOCKS IN AMERICA**


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<b>Company Name</b>	<b>Market Value as of mid-2001</b>
1. General Electric	\$432.1 billion
2. Microsoft	353.2
3. ExxonMobil	288.1
4. Pfizer	260.2
5. Citigroup	252.7
6. Wal-Mart Stores	249.9
7. AOL Time Warner	201.3
8. Intel	200.5
9. American International Group (AIG)	194.2
10. IBM	184.9

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Exchange. The S&P tracks 500 companies with an average market value of \$21.8 billion.

The bigger you are, the harder it is to grow quickly, so large caps don't tend to expand as fast as your average technology upstart. But what they lack in flash, they make up in heft. The classic blue chip has steady revenue, a consistent stream of earnings, and a dividend. It also has critical mass, which means it can withstand ill economic winds better than its smaller cousins.

The 1990s ushered in a new breed of large caps that grow much faster than most blue chips. We're talking about mature technology wonders like Microsoft, Intel, and Cisco Systems. They're a little more volatile—okay, sometimes a *lot* more volatile—than a blue chip like Wal-Mart. But when it comes to catching a piece of future economic growth, they're hard to beat.

One caveat: Some small companies achieve large-capitalization status because of unbounded investor enthusiasm. In 1999, for example, some Internet companies like Priceline.com soared to large-cap status, even though they were unprofitable and lacked a proven track record. In April 1999, Priceline.com was valued at more than \$23 billion—but that didn't last long. Near the end of 2000 its market capitalization had shrunk down to a

mere \$316 million. Lesson learned? Some companies might look like large caps, when they're really just bloated small or mid-caps. Clearly, there's nothing steady about companies like these.

Because of their size and stability, large-cap stocks are not generally speculative in nature and appeal to a more cautious investor. That's not to say they can't run into serious trouble, but they tend to grow along predictable trend lines and, since they are well known to Wall Street analysts, their problems often come with ample warning. Big companies (with the notable exception of many technology blue chips) also tend to pay regular dividends, which act as ballast by attracting income-oriented, long-term investors. Don't be fooled: Large caps can experience jarring price swings. But there's no doubt they are less volatile than small, hot-growth stocks.

Lower risk comes with a price, however. Except during periods of rampant uncertainty, large-cap stocks tend to produce lower returns than small caps (11.2 percent annually versus 12.8 percent).

## Small Stocks

Small-capitalization stocks are known as the market's speed demons. That's not entirely accurate, since there are plenty of small, stodgy banks and rust-belt manufacturers in the group. And there are periods when small caps suffer because investors have no stomach for high volatility. But companies with a market value below \$1 billion can also grow more quickly than bigger companies. Indeed, the good ones can post explosive earnings that drive double-digit returns for investors.

There are several indexes that track small-cap stocks. Probably the most widely referenced is Frank Russell Co.'s Russell 2000, which tracks 2,000 companies with an average capitalization of \$530 million. Companies in Standard & Poor's small-cap index, the S&P 600, average about \$625 million in market value. Most people, however, consider any company below \$1 billion a small cap.

Small-cap companies tend to have correspondingly small revenues. And that means many of them have either just started up or are poised to expand their markets, either geographically or with new products. Dianon Systems is a good example. The Stratford, Connecticut-based operator of medical testing labs had a market value of right around \$300 million as 2000 turned into 2001. Yet, because it was so small, it was able to grow much faster than

a health-care giant like Johnson & Johnson, which had a market value of more than \$130 billion.

Johnson & Johnson makes everything from Band-Aids to replacement hips. And over the five years from 1996 to 2000, its stock gained 131 percent, based on annual earnings growth of 15 percent. Not bad for a large cap. But over the same period, Dianon gained more than 1,000 percent as its earnings soared, on average, 444 percent per year. (See Figure 1.2.)

Of course, Dianon was also more volatile than Johnson & Johnson. And the smaller company ought to be much more vulnerable than the mighty Johnson & Johnson during an economic downturn. But Dianon's incredible performance over the past few years would have been a great sweetener to any diversified portfolio.

There are other risks as well. When the economy is uncertain, as it was, for example, in 1997 when the Asian crisis sent global stock markets reeling, investors looking for safety and stability will often abandon small caps for blue chips. Also, because small companies have fewer shares outstanding, their price movements are necessarily more erratic. When good news hits, investors clamoring to get in will drive the price up quickly. When bad news hits, the opposite is true, and it can sometimes be difficult to get out. Because fewer Wall Street analysts cover these stocks, there's also less reliable in-

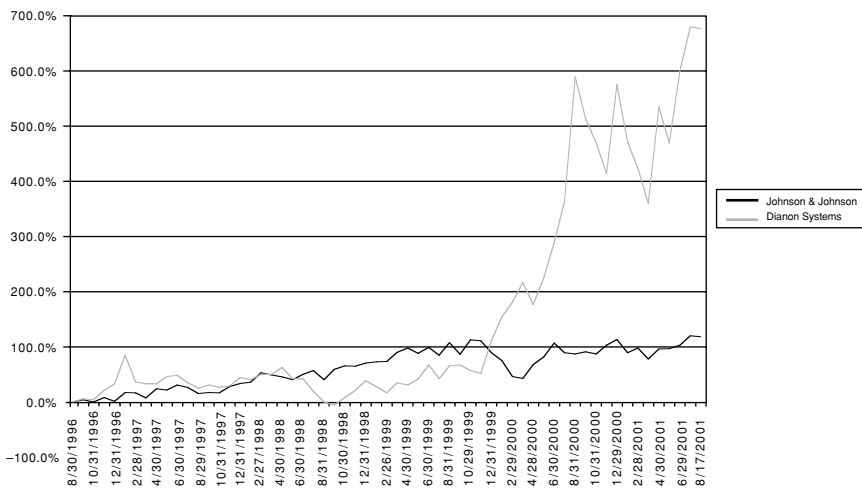


FIGURE 1.2 Johnson & Johnson versus Dianon Systems

formation on them. That means bad news can strike out of the blue, decimating stock prices overnight.

For all of that, however, most investors—especially young ones who have the time to make up any losses—want exposure to small caps. As we saw with Dianon, the upside potential is simply too great to pass up.

## Foreign Stocks

At a time when the world economy has become increasingly interconnected, investors can hardly afford to ignore foreign stocks. There's too much opportunity out there and too many ways to tap it. And since the economies of the world's different regions tend to boom and bust in cycles that often offset each other, international stocks can provide excellent diversification for a portfolio heavy on U.S. equities.

Like stocks on the U.S. exchanges, foreign stocks vary in size and do not move as a single group. So you can't really say how a "Japanese stock" behaves, or how an "Italian stock" will perform. It's also true that foreign companies are subject to different rules of accounting and far less government scrutiny than U.S. investors are used to. It all adds up to this: Investing abroad is more complicated than buying stocks in the United States.

That's why most U.S. investors get international exposure either by investing in large, well-established overseas companies like Finland's Nokia or by putting their money in professionally managed mutual funds that have the expertise and resources to assemble winning portfolios from a host of different foreign stocks.

Buying an international mutual fund is no different from buying a domestic one. As for individual stocks, you can either buy the stocks through a broker directly on foreign markets or purchase what are known as American depositary receipts (ADRs) on U.S. exchanges. These shares are surrogates for foreign shares, but have dollar values and move according to the performance of their foreign issuers.

International markets are nothing if not volatile. They are highly susceptible to changes in foreign exchange rates, as well as shifts in regional and global economies. As the global economy slowed in 2000, for instance, stocks in most areas of the world slowed, too. But international markets are rarely that monolithic. Usually one region is up while another is down.

A dramatic example of that sort of divergence came in 1998 during the

meltdown among the Asian economies. Economic turmoil in a region that was once the financial world's darling taught a lot of investors about the treachery of betting your money abroad. Japan's Nikkei index lost almost 40 percent between June 1997 and October 1998, as trading partners throughout the Pacific Rim imploded due to financial mismanagement and corruption. The ripple effects were felt worldwide as companies with exposure to those markets lost revenues.

At the same time, however, European markets blossomed as the Continent came closer to true economic union and a rash of U.S.-style corporate restructurings began to pay dividends. One region collapsed; another made up for it. That's why it makes sense to diversify your foreign investments, or let a professional money manager do it for you.

## Tech Stocks

We live in an age when technology can change our lives seemingly overnight, and that ability creates rich new markets and explosive earnings growth for countless companies.

Of course, as investors learned in 2000 and 2001, there's a dark side to all that opportunity. Fearful of an economic slowdown, investors abandoned growth stocks and looked for safety in less volatile sectors like pharmaceuticals. Profitless Internet stocks like Amazon.com felt the worst impact. But even big, established technology companies like Cisco Systems and Sun Microsystems took a drubbing.

New markets are by nature filled with danger, and that means actual earnings—or the prospect of future earnings—can fluctuate wildly. News of a personal computer (PC) sales slowdown at Christmas can cause investors to flee any number of related stocks—from PC maker Gateway to Novellus Systems, which makes the equipment that fabricates the chips that power the PCs that Gateway sells. Investors will return to the good companies once the dust has cleared. But unless you have patience and staying power, such crises can easily wipe you out.

As the tech roller-coaster ride of the past few years has demonstrated, technology stocks as a group tend to be more volatile than the broader market. Still, a selection of high-tech blue chips should be in everyone's long-term portfolio, since the volatility they do exhibit is easily offset by their

superior growth over time. We'll talk about where to find them—and a lot more—in the pages ahead.

But before we get to that, let's have a few words about another candidate for your investment portfolio.

## Bonds

Think of a bond as an IOU. Buy one and you are in effect lending money to the issuer—whether it's the U.S. Treasury or U.S. Airways Inc. The issuer promises to pay you interest until the bond is due, at which point you'll get your principal back.

Bonds, with their steady stream of income, can add much-needed ballast to an otherwise volatile long-term portfolio. Here are the main types of bonds you should consider buying. We'll help you decide how much exposure to bonds you want in Chapter 3, when we discuss your ideal asset allocation.

### Buying Directly from the Treasury

If you are just starting out, you can simply buy five-year Treasury securities, or—if you have a large amount of assets allocated for bonds—you can put together a so-called ladder of Treasuries. We'll show you how in a moment. Either way, your best bet for buying bonds and notes is the government's commission-free Treasury Direct program, which allows you to bypass brokers and their fees. An application to open an account may be obtained online by visiting the Treasury Direct web site ([www.treasurydirect.gov](http://www.treasurydirect.gov)) or by contacting your nearest Federal Reserve Bank. You can also call the U.S. Bureau of Public Debt at 800-722-2678.

Two-, three-, five-, and ten-year notes are available for a \$1,000 minimum investment. You can set up an account online. If for some reason you need to sell the Treasuries in this account before they mature, you will have to have them transferred to a broker, who will charge at least \$50 per transaction. In addition, Treasury Direct accounts of \$100,000 or more face an annual \$25 maintenance fee.

## Agency Bonds

Also extremely safe and liquid, but offering a slightly higher yield, are government-agency bonds issued by the likes of the Tennessee Valley Authority, Farm Credit Financial Assistance Corporation, Federal National Mortgage Association (FNMA), and Government National Mortgage Association (GNMA). (These debentures should not be confused with the mortgage-backed bonds that are also issued by FNMA and GNMA; mortgage-backed securities are extremely sensitive to fluctuations in interest rates and should be avoided.)

It's hard, however, to gain any edge with these agency bonds over Treasuries. That's because they're generally available only through brokers and thus incur commission costs that cut into their yields. How much? The standard retail brokerage fee comes out to 0.5 percent, or in the lingo of the bond world, 50 basis points. Even if you have \$100,000 to invest and negotiate a lower commission, perhaps 20 basis points, the advantage over Treasuries will probably come to only around \$50 a year.

There might be an exception if you have a very large portfolio and can sink perhaps \$1 million into agency bonds; you might then be able to get the institutional commission rate of just 10 basis points. Or, at a more modest level, you might be able to hook up with a financial adviser who specializes in making bulk government-agency bond purchases directly from banks, lumping clients' investments together in order to build million-dollar packages of agency debentures.

## Muni Bonds

Investors with substantial income should also consider combining tax-free municipal bonds with their Treasuries. While the stated yields of munis are lower than those of Treasuries, the effective return for investors in high tax brackets is almost always better. As with Treasuries, individual muni bonds can also be laddered to limit your interest-rate exposure. But because they tend to trade in fairly large lots (usually \$5,000 to \$25,000) and because investors should spread their money among a variety of different locales as a precaution against default risk, building a muni portfolio requires a commitment of \$100,000 at a bare minimum.

If you don't have enough now to build a muni ladder, the next best op-

tion is to look to a series of municipal-bond mutual funds. The best are Vanguard's Limited-Term Tax-Exempt and Intermediate-Term Tax-Exempt funds (which both have a minimum initial investment of \$3,000). They maintain a low 0.18 percent expense ratio and are run with minimal maturity fluctuation and risk-taking.

## What About Corporates?

While investors have traditionally been steered to corporate bonds because they offer higher interest income than government bonds, we are dubious about endorsing them. In part, it's a question of costs eating into those higher yields. First there are the taxes: Income from corporates is fully taxed at all levels. If your state and local rates (which are not applicable to government bonds) are a mere 6 percent, that would cut the effective return of an 8 percent yield to 7.5 percent. Next come the transaction costs: both brokerage commissions and the cut taken by the bond dealers (known as the spread). All told, they can easily eat up 1 percent or more of your investment.

Perhaps most important, though, is that the best bonds are usually callable by the issuer, meaning the corporation can, at its discretion, pay off its obligation at a stated price and stop paying interest. That becomes a heads-you-win, tails-I-lose proposition for investors. If interest rates decline and the value of the bonds goes up, the corporation may call them, disrupting your expected income stream and cutting off a potential capital gain. Alternatively, if interest rates rise you are stuck holding a less valuable security that is yielding below-market rates.

## Up the Ladder

Diversification is as important in bond investing as it is in stock investing. It's best to spread your risk over a series of different maturities, while maintaining an average maturity of your liking in your portfolio. The best way to do that is to set up a ladder of Treasuries—in essence, a series of notes with a range of maturities. (Treasury notes have maturities of 1 to 10 years, while bonds have maturities of more than 10 years.)

Here's how it works: You buy equal amounts of Treasuries due to mature in one year, three years, five years, seven years, and nine years. That portfolio

**16** THE SMARTMONEY STOCK PICKER'S BIBLE

would have an average maturity of five years (one+three+five+seven+nine, divided by five, equals five). The next year, when the first batch comes due, you would reset the ladder by putting the money into new 10-year notes. Your portfolio would then have an average maturity of six years.

Two years later, when the next round of notes matures, you would buy more 10-year notes, continuing to buy new 10-years whenever a note matures. That would always keep the average maturity in the five- to six-year range.

One advantage to this scheme is that you don't need to worry about fluctuations in interest rates—especially if the ladder you construct has notes coming due each year. If rates do rise soon after you bought this year's bonds, you can take comfort in the fact that soon you will have money coming available to take advantage of the change by purchasing your new 10-years at lower prices. Similarly, if rates decline after you buy, you've managed to lock in the higher rates for that portion of your portfolio. The bottom line is, you won't get stuck one way or the other.

Treasuries for your ladder may be purchased straight from the U.S. government through the Treasury Direct program (mentioned earlier), with few fees and low minimum investments.

A ladder may also be constructed of municipal bonds, but that would typically require a bare minimum of \$100,000 in capital to gather a diversified group of issues. Trading in a muni, which you can do through most brokerage firms, also creates higher transaction costs, but if your tax rate is high enough—probably anywhere above 28 percent—the tax savings may make the costs worthwhile.

## **Bond Funds versus Your Own Portfolio**

Bonds are complex—there's no doubt about it—especially if you're a novice investor with little experience in the markets. That's why a lot of people opt for bond funds when they seek to diversify their investments with some fixed-income exposure. Our view is that if you're willing to put in the effort, you're better off buying individual bonds instead of bond funds. But in the real world, the convenience of a fund is sometimes worth the drawbacks.

Here's what you have to consider:

Like a stock mutual fund, a bond fund is managed by a professional investor who buys a portfolio of securities and makes all the decisions. Most

funds buy bonds of a specific type, maturity, and risk profile—15-year corporates, for instance, or tax-free municipals—and pay out a coupon (interest rate) to investors, often monthly, rather than annually or semiannually like a regular bond.

The chief advantage of a bond fund is that it's convenient. It's also true that when it comes to buying corporate and municipal bonds, a professional manager backed by a strong research organization can make better decisions than the average individual investor. Consequently, if you want to dabble in junk bonds or shelter your income with triple-tax-free New York City 30-year bonds, you may be better off going the easy route and picking a good fund.

The main disadvantage of a bond fund is that it's not a bond. It has neither a fixed yield nor a contractual obligation to give investors back their principal at some later maturity date—the two key characteristics of individual bonds. Then there are the fees and expenses that can cut into returns. Finally, because fund managers constantly trade their positions, the risk-return profile of a bond-fund investment is continually changing: Unlike an actual bond, whose risk level declines the longer it is held by an investor, a fund can increase or decrease its risk exposure at the whim of the manager.

The other thing about building your own portfolio of bonds is that you can tailor it to meet your circumstances, meaning the bonds will mature precisely when you need them. A bond fund cannot deliver that sort of precision.

Our advice is this: If you lack the time or interest to manage a bond portfolio on your own, or if you want a mixed portfolio of corporates or municipals, buy a bond fund. But if you want a tailored portfolio of Treasuries to mature when your child goes to college, and you want to avoid the fees and added risk associated with bond funds, go ahead and take the plunge yourself.