

Chapter

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Buying and Selling Securities

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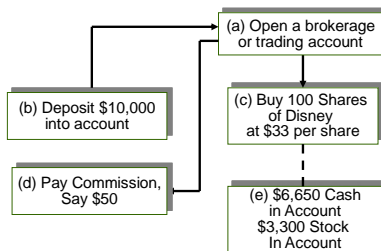
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Buying and Selling Securities

- This chapter covers the basics of the investing process.
- We begin by describing how you go about buying and selling securities, such as stocks and bonds.
- Then, we outline some important considerations and constraints to keep in mind as you get more involved in the investing process.

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Getting Started



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Choosing a Broker, I.

- Brokers are now divided into three groups:
 1. Full-service brokers
 2. Discount brokers
 3. Deep-discount brokers
- These three groups can be distinguished by the level of service provided, as well as the level of commissions charged.

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Choosing a Broker, II.

- As the brokerage industry becomes more competitive, the differences among broker types continues to blur.
- Another important change is the rapid growth of *online brokers*, also known as *e-brokers* or *cyberbrokers*.
- Online investing has really changed the brokerage industry.
 - slashing brokerage commissions
 - providing investment information
 - Customers place buy and sell orders over the Internet

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Securities Investor Protection Corporation

- **Securities Investor Protection Corporation (SIPC):** Insurance fund covering investors' brokerage accounts when member firms go bankrupt or experience financial difficulties.
- Most brokerage firms belong to the SIPC, which insures each account for up to \$500,000 in cash and securities, with a \$100,000 cash maximum.
- **Important: The SIPC does not guarantee the value of any security (unlike FDIC coverage).**
- **Rather, SIPC protects whatever amount of cash and securities that were in your account, in the event of fraud or other failure.**

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Broker-Customer Relations

- There are several important things to remember when you deal with a broker:
 - Any advice you receive is **not** guaranteed.
 - Your broker works as your agent and has a legal duty to act in your best interest.
 - However, brokerage firms make profits from brokerage commissions.
- Your account agreement will probably specify that any disputes will be settled by arbitration and that the arbitration is final and binding.

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Brokerage Accounts

- A **Cash account** is a brokerage account in which securities are paid for in full.
- A **Margin account** is a brokerage account in which, subject to limits, securities can be bought and **sold short** on credit.

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Margin Accounts

- In a **margin purchase**, the **portion** of the value of an investment that is **not borrowed** is called the **margin**.
- Of course, the portion that is borrowed incurs an interest charge.
 - This interest is based on the broker's **call money rate**.
 - The call money rate is the rate brokers pay to borrow money to lend to customers in their margin accounts.

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Margin Accounts

- In a margin purchase, the **minimum margin** that must be supplied is called the **initial margin**.
- The **maintenance margin** is the margin amount that **must be present at all times** in a margin account.
- When the **margin drops below the maintenance margin**, the broker can demand more funds. This is known as a **margin call**.

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Hypothecation and Street Name Registration

- **Hypothecation** is the act of pledging securities as a collateral against a loan.
- This pledge is needed so that the securities can be sold by the broker if the customer is unwilling or unable to meet a margin call.
- **Street name registration** is an arrangement under which a broker is the registered owner of a security. (You, as the account holder are the "beneficial owner.")

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Other Account Issues, I.

- Trading accounts can also be differentiated by the ways they are managed.
 - **Advisory account** - You **pay** someone else to make buy and sell decisions on your behalf.
 - **Wrap account** - All the expenses associated with your account are "wrapped" into a single fee.
 - **Discretionary account** - You **authorize** your broker to trade for you.
 - **Asset management account** - Provide for complete money management, including check-writing privileges, credit cards, and margin loans.

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Other Account Issues, II.

- To invest in financial securities, you do not need an account with a broker.
- One alternative is to buy securities directly from the issuer.
- Another alternative is to invest in *mutual funds*.

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Short Sales, I.

- **Short Sale** is a sale in which the seller does not actually own the security that is sold.



Note that an investor who buys and owns shares of stock is said to be "*long the stock*" or to have a "*long position*."

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Short Sales, II.

- An investor with a long position benefits from price increases.
 - Easy to understand
 - You buy today at \$34, and sell later at \$57, you profit!
 - **Buy low, sell high**
- An investor with a short position benefits from price decreases.
 - Also easy to understand
 - You sell today at \$83, and buy later at \$27, you profit.
 - **Sell high, buy low**

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Investment Objectives

- Fundamental Question: Why invest at all?
 - We invest today to have more tomorrow.
 - Investment is simply deferred consumption.
 - We choose to wait because we want more to spend later.
- In formulating investment objectives, the individual must balance return objectives with risk tolerance.
 - Investors must think about risk and return.
 - Investors must think about how much risk they can handle.

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Investment Strategies and Policies

- **Investment management.** Should you manage your investments yourself?
- **Market timing.** Should you try to buy and sell in anticipation of the future direction of the market?
- **Asset allocation.** How should you distribute your investment funds across the different classes of assets?
- **Security selection.** Within each class, which specific securities should you buy?

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Investor Constraints

- **Resources.** What is the minimum sum needed? What are the associated costs?
- **Horizon.** When do you need the money?
- **Liquidity.** How high is the possibility that you need to sell the asset quickly?
- **Taxes.** Which tax bracket are you in?
- **Special circumstances.** Does your company provide any incentive? What are your regulatory and legal restrictions?

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