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.

Getting Started

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.

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

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.
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.

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.

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.

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**.

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.”)

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.
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.

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."

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**

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.

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?

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?