# How to Buy and Sell Stocks

## Brokers

To buy or sell a stock, you usually have to go through a broker. Some brokers, usually called full-service brokers, provide a range of services beyond filling buy-and-sell orders for clients, such as researching investments and helping you develop long- and short-term investment goals.

Discount brokers carry out transactions for clients at lower fees than full-service brokers but typically offer more limited services. For experienced investors who trade often and in large blocks of stock, there are deep-discount brokers whose commissions are even lower.

## Online

Online trading is the cheapest way to trade stocks. Online brokerage firms offer substantial discounts while giving you fast access to accounts through their Web sites. You can research stocks, track investments, and follow the latest market developments. Some online firms even enable you to trade before and after normal market hours. Most of today's leading full-service and discount brokerage firms make online trading available to their customers.

Online trading is an extremely cost-effective option for independent investors with a solid strategy who are willing to undertake their own research. However, the ease of making trades and the absence of advice may tempt some investors to trade in and out of stocks too quickly, and magnify the possibility of locking in short-term losses.

## Direct

You may also be able to buy stock directly from the company that issues it through a dividend reinvestment plan (DRIP). If you sign up, your dividends are automatically reinvested to buy more shares, and you can make additional cash purchases as well. A number of large companies offer these plans and charge only a minimal fee to handle your transactions. One drawback of using a DRIP, however, is that it may take more time to sell stocks that are held in a company account than it does to sell shares held in a brokerage account.

## Short Selling

A short sale is the sale of a security, which you do not own. The process is heavily regulated, and at a point in time, the seller must "Cover" (purchase the stock sold). Ideally, at the point when the short sale is purchased, the price of the company will be lower than at the time it was sold, thus generating a profit for the investor. Short sales are done at brokerage firms by utilizing a margin account (the brokerage firm "Lends" the stock to the customer).

Short sellers are pessimists, expecting prices to go down. To profit from this anticipated drop as a short seller, you borrow shares of a stock from your broker, sell — or short — the shares, and pocket the money gained from the sale. If the price goes down — as you calculated it would — you buy back shares at the lower price and return the number of shares you borrowed to your broker. After you pay interest and commissions, you expect to have made more on the initial sale of the borrowed stock than it cost you to sell and repurchase the shares.

The strategy can backfire, however, if the stock price goes up rather than down, or even if the price is stable for an extended period. Interest charges mount, and you may decide to cover your short position by buying shares at a higher price than you realized when you sold them. That will leave you with a loss. And if the price continues to rise, your costs — and potential losses — will mount.

## Risks of Investing in Stocks

Investors buy a stock when they believe it's a good investment. More demand drives the stock price up. But if people think a company's outlook is poor, and either don't invest or sell shares they already own, the stock price will fall. In effect, investor expectations determine the price of a stock. In short, stock pricing follows the economic principle of Supply and Demand we discussed in Session One.

For example, if lots of investors buy Stock A, its price will be driven up. The stock will become more valuable because there is demand for it. But the reverse is also true. If a lot of investors sell Stock Z, its price will plummet. The further the stock price falls, the more investors sell it off, driving the price down even more. These conditions are not permanent; too much demand may cause a bubble, and lower prices make investment more attractive.

Investor enthusiasm for a stock can sometimes take on a momentum of its own, driving prices up independent of a company's actual financial outlook. Investor disinterest can drive prices down in a similar manner. This provides an excellent example of the Invisible Hand of Adam Smith's Market Economics in action.

Many investors, however, disregard market trends and base their expectations on a company's sales and earnings, as quantifiable evidence of its current strength and future potential. When a company's earnings are up, investor confidence increases and the price of the stock usually rises. If the company is losing money— or not making as much as anticipated — the stock price usually falls, sometimes rapidly. The rising stock prices and regular dividends that reward investors and give them confidence are tied directly to the financial health of the company.

Dividends, like earnings, often have a direct influence on stock prices. When dividends are increased, the message is that the company is prospering. This in turn stimulates greater enthusiasm for the stock, encouraging more investors to buy, and driving the stock's price upward.

When dividends are cut, investors receive the opposite message and conclude that the company's future prospects have dimmed. One typical consequence is an immediate drop in the stock's price. Companies known as leaders in their industries with significant market share and name recognition tend to maintain more stable values than newer, younger, smaller, or regional competitors.

There have always been speculative bubbles—periods when stock prices have risen to unsustainable levels on investor optimism. The late 90's was one such period, as were the bull markets of 1970 to 1972 and 1982 to 1987. Usually, a period of very high stock prices is followed by a period of depressed prices. Stocks become undervalued — or fall lower in price than a company's prospects would seem to warrant — when investors overreact to negative news, such as a company profit warning, rising interest rates, or political or economic upheaval at home or abroad.

### Rating Systems and Indices

There are a wide range of rating systems and indices to represent various components of the markets. Most financial service firms, especially brokerage houses, rate the stocks they follow independently. The most common rating system divides securities into "Buy", "Sell", or "Hold" categories (or some variation thereof).