

Stocks: The Basics

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There are many advantages to investing in stocks. But in order to make the most of them you need to understand a few essentials about the stock market and how stocks work.

How a Stock Market Works

The stock market might seem mysterious, but the inner workings of the market are no big secret. Have you ever attended an auction? When you buy an object at auction, you aren't buying from the auctioneer. It's the auctioneer's job to match buyers with sellers, and to get the best price possible for the seller. Since there's no fixed price for any auction item, the selling price is set by the amount that a buyer is willing to pay. The stock market works in similar fashion. It's an auction-based market, and a stock broker is an intermediary who serves to match buyers and sellers of stocks.

How a Stock's Price is Set -- and Why it Changes

The price of a stock trade depends upon how little the seller will accept and how much the buyer is willing to pay. So what are all those prices you see in the stock tables in the newspaper or on an Internet quote server? The prices you see are the prices of the last trades of the prior day or the prices of the most recent trades. You can also find the best price that buyers will pay for a share at the current time, as well as the best price that sellers will accept. If you're buying, the price you pay for shares may be worse or it might be better than the most recent quoted price -- by a little or a lot.

A stock's price is constantly changing--rising and falling by a few pennies (or even a few dollars). There are many factors that can cause a stock's price to change, and not all of them are rational. Investors often buy or sell a stock out of fear or some other emotion, and not because it's the "logical" thing to do. In addition, investors often exhibit a herd-like mentality, basing their own buy or sell decisions on what everyone else is doing. Sometimes, this overreaction can create opportunities for investors who are willing to run against the pack, buying a stock when it has been temporarily depressed or selling when a stock's price has been elevated for no apparent reason.

The Advantages of Stocks

The first thing you need to know about investing is this: Over the long term, common stocks have tended to outperform nearly all other assets. In the history of the U.S. stock markets, common stocks have had an average annual return of about 14 percent since the end of World War II. Of course, there have been some rocky patches along the way--years in which the market has dropped 20 percent or even more. And you do run the risk of needing to sell your stocks in such times. While these periods can be painful, it's important to realize that the market has eventually recovered from each downturn and then marched onward.

The Stock Market Marches Onward and Upward

If there's one thing we've learned in the 200-year history of the U.S. stock market, it's that the markets are incredibly resilient. The stock market goes through some bad periods, to be sure, but at some point it always bounces back -- if you give it time. In fact, the longer you have before you need to start taking money out of your portfolio, the better your chances of eventually earning a decent return from your investments. But most financial professionals are quick to counsel that you shouldn't invest heavily in the stock market if you need your cash from those investments in less than five years. That doesn't mean you should avoid investing in stocks entirely if you're 58 years old and looking to retire at age 63 -- after all, you'll be drawing down your retirement funds for 15 to 20 years (or even longer), so stocks could be still be part of your overall financial plan.

Avoiding Capital Gains Tax

Another advantage of long-term investing comes from avoiding unnecessary taxes. Whenever you sell a stock at a higher price than you purchased it, you must pay a capital gains tax on the profit. It may be long-term or short-term tax, but the most important thing to remember is that taxes can significantly reduce your portfolio's overall returns. If you trade stocks frequently, even if you are able to do so profitably, capital gains taxes can take a big bite out of your returns. In fact, academic research has demonstrated that frequent traders are often less successful with their portfolios than long-term investors, due to the effects of taxes and commissions. Constantly buying and selling stocks can be great for your broker and accountant, but it's unlikely to fatten your portfolio.

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