

INVESTMENT *facts*

No. 4

The Stock Market

About *INVESTMENT facts*

Investment Facts is published by the Investor Learning Centre of Canada, an independent not-for-profit organization. Our aim is to help people like you become better informed about your investment choices.

The ILC works closely with the Canadian Securities Institute – the official educator of the securities industry – and other highly regarded organizations. This helps ensure our publications and programs are accurate and non-promotional.

This issue of Investment Facts is part of an ongoing series. It complements our many other national investment learning programs, including books, seminars and a walk-in-phone-in resource centre.

For more information, call one of our offices listed on the back page. We'll be happy to help!

Can you review for me what shares are?

As businesses grow, the demand for funds to spur growth and development often grows, too. Many entrepreneurs borrow money, but another option is available. A part or share of the business can be sold.

A share, then, is a unit of a company that represents ownership or *equity* in it. An investor who buys a share is not lending money to the company. In a very real sense, the investor is putting savings directly to work in the company's business. If it prospers, the shareowners will also prosper in direct relation to the number of shares owned. If it fails, the investor holding its shares may lose money.

The option of raising money by selling shares or *equity* is only rarely open to governments. That is because they have few assets to sell. They tend to borrow through the bond market instead.

Tell me about the different kinds of shares.

A company can issue either *preferred* or *common* stock. Preferred stocks pay shareholders a fixed dividend but do not normally have voting rights. If the company is liquidated, preferred shareholders will have a claim to a set dollar value per share of the assets. This right comes after the claims of bondholders and other creditors but before common shareowners.

Preferred shares are similar to fixed-income products like bonds. Their prices rise and fall in response to interest rates. People buy preferreds for the same reason they buy bonds – for the regular income. Preferreds do have some advantages, however. Income from dividends is taxed at a lower rate than income from bond interest.

Common shares do not always pay a dividend. The return from these shares is usually from the capital gain earned if they increase in value after you buy them. That's why prices for common shares can be more volatile than prices for preferreds. Over time, they move up and down due to factors like the economy and company performance.

You can also buy preferred stock that is *convertible* into common stock at a set price for a limited time. The market price of convertible preferreds will vary more than other preferreds because to the investor they look more like common stock than fixed income shares.

Remember that a company may issue different *classes* of common stock. These classes may have no, or limited, voting rights.

Is common stock more risky than preferred?

Yes. But lots of common stocks aren't that risky. You can help to hedge your bets by looking at the company's track record, at its dividend payment record, and by carefully examining the company's financial reports. Normally, the more stable the company and its earnings, the more stable its stock price will be.

All of this information, as well as a buy, sell or hold recommendation, is available from most investment dealers' research departments. This can be invaluable in helping you make your investment selection.

What are my rights as a shareholder?

As a shareholder, you are part-owner of the business and normally have a right to share in management decisions and to share in profits. Your voice in company affairs is expressed when you vote at the company's annual meeting. You usually get one vote for each share you own. Profits are issued to shareowners at intervals in the form of dividends.

Keep in mind that a company doesn't have to issue dividends or make up for unpaid dividends on common shares. Also, some companies limit their shareholders' voting rights. Before you invest, look at the company's record in paying dividends and check what

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voting restrictions the shares might have.

Shareholders are also entitled to get regular information about the company's activities. This includes annual and interim financial statements, and ongoing news about things that can affect the value of your shares.

If the company goes bankrupt, common shareholders have last claim on the company's assets.

How does a company decide whether to borrow or to sell shares?

A company needs to weigh many factors before deciding. The economy will be important. If the country's in recession, stock prices could be depressed. Issuing more stock may not be the best way to raise money. If interest rates are falling, the bond market may be better because the cost of paying interest to investors will be lower. Alternatively, with stock the company will not have to pay regular interest or account for repayment. Dividends don't have to be paid if the company is going through lean times. However, a company may not want to give up any ownership even if issuing shares is cheaper.

An investment dealer helps a company decide whether to issue bonds or shares.

When a company decides to issue shares, what happens next?

The process of bringing shares to the market for the first time is called an *initial public offering* (IPO), a *new offering* or a *new issue*. The investment dealer that helps bring the new securities to market is the *underwriter*.

The company and the underwriter determine the details of the offering such as type and price. Special features attractive to investors are designed. A few weeks before the offering, the company must register a *preliminary prospectus* with the securities administrator in each province where the offering will be sold. This is a lengthy document describing the company, its history and officers, and information on the offering. It can be used to solicit investor interest in the stocks. The prospectus is checked by the securities administrators to ensure all important details are disclosed. But even if the securities administrators approve a prospectus, this does not mean that the stocks are a good investment. The administrators don't endorse the securities

nor do they vouch for the accuracy of the information in the prospectus. They simply try to ensure that all important information about the company and the shares is made public.

Sometimes, a new issue can be sold without a prospectus if it's being sold only to big investors. These investors are called *exempt purchasers* and are mostly financial institutions.

If you are looking at a new issue, be sure you or your advisor reviews the preliminary prospectus. The final version of the prospectus is filed just before the shares are distributed. This is where you will see the final share price instead of only a price range.

The company and the investment dealer then work out what role the dealer will play in distributing the issue. A dealer can buy the whole issue, either alone or as a part of a group called a *banking group*. In this situation (called a *bought deal*), the dealer will resell the shares to investors or put them in the firm's inventory. The dealer can also act as an agent, simply locating investors who might want to buy the shares from the company. This is called a *best efforts* underwriting. Most companies prefer a bought deal underwriting because they are guaranteed a certain amount of money and don't need to take back any shares that aren't sold.

You haven't mentioned stock exchanges. What's their role?

They play a very important role in our capital markets. They are better known as *secondary markets*. Companies can use stock exchanges to raise new capital, but most of the trading you hear about in business reports on radio and TV is trading among investors (secondary trading). The seller is no longer the company which issued the stock, but someone who bought the stock earlier, either as a new issue or from another investor.

You should know, however, that stock exchanges can be used in Canada for a company's first distribution of shares. If you encounter one of these, be sure you review the *Statement of Material Facts* or the *Exchange Offering Prospectus* describing the offering and the company. They are similar to

prospectuses filed in more usual offerings.

Once a company decides to issue stock for broad distribution, which is what is meant by *going public*, the company can have its shares traded on a stock exchange or in another public market. Only stocks which are *listed* on a stock exchange can be traded there.

Why is it important to have a secondary market?

Without a secondary market, investing in companies would be so difficult, time consuming and expensive that it might not be worthwhile. Imagine if you bought shares from a company and then wanted to sell them. Without a convenient secondary market, you'd have to go out yourself and try find a buyer for your shares. This could take a long time, and you might have to spend a lot of money on advertising to let people know you want to sell. With a strong secondary market people can choose to buy from a wide range of available shares at any time, not just when they are newly issued. They can buy and sell when they want to. Investors can make quick decisions about the value of a company and act on them immediately. Unlike many other kinds of markets (e.g. real estate), stock exchanges are very *liquid*, meaning you can often get money for your shares in a few days.

Companies rely on active secondary markets to help them raise money in the primary markets. If one class of shares on a stock exchange is in demand, a new issue would likely be attractive, too. That means the company would be able to raise more money for the same costs. If stock prices are depressed, the company might choose other financing.

Are all stock exchanges the same?

No. While the shares of many major companies are listed on a lot of stock exchanges, exchanges often specialize in different kinds of listings. Some set quite onerous conditions for the kind of company that can list its shares, while others have less strict standards. Some may seek out small, start-up companies, while others prefer senior or *blue chip* companies that are big and established.

In Canada, the CDNX is the exchange which specializes in *junior* or brand-new companies. Senior companies are listed on

The more stable the firm, the more stable the stock price.

the Toronto Stock Exchange, although the TSE also lists junior companies.

These exchanges play important roles in the capital formation process. The CDNX helps new companies get off the ground. Toronto offers bigger companies access to large capital pools.

Are junior stocks riskier?

Junior stocks are more likely to be risky. This is because the company issuing the stock hasn't been in business long enough to build a track record of profits and dividends. Stock exchanges monitor such companies, but this can't compensate for the risk of being new and unproven.

This does not mean you will lose all your money if you invest in these stocks. There are some very sound and promising companies listed. Don't ever think, either, that stocks on more senior exchanges are risk-free. Any stock investment, no matter where it's listed, has to be judged carefully with agreed-to objectives and a clear assessment of the risk involved. If the risk is high, you should always be prepared to lose your investment.

Can anyone buy and sell on a stock exchange?

You can buy and sell any stock listed on a stock exchange but you can't do it yourself. Stock exchanges are owned by the member brokerage firms and investment dealers. All orders must go through a member who owns a *seat* on the exchange. Owning a seat means the firm has met the membership admission standards and can trade in the stocks listed there.

How are stocks traded on the exchange?

Stocks, especially the better known ones, tend to trade in an *auction* market. Buying a stock is like buying an antique at an auction house. The auctioneer is paid a commission to sell the antique to the highest bidder. If there aren't lots of bidders, the price will be lower than if lots of people want to buy it.

Similarly, members bring orders to a stock exchange for auctioning. Both the TSE and the CDNX only accept orders electronically. The New York Stock Exchange still has a physical trading floor where orders are executed by traders. The goal in both cases is to expose all buy orders for a stock to all sell orders. That way, the best deal can be struck.

So how is a price established?

Both buy orders (*bids*) and sell orders (*ask*) will have a price attached to them. There is always a difference between what is being asked and what is being bid. This is called the *spread* and the difference is usually quite small, especially for more popular stocks. Big spreads often indicate a lack of demand and the shares may take longer to sell. The final price might be at either the bid or the ask, but could also be somewhere in between. Which it will be is negotiated by the traders and will depend on lots of factors such as order size.

Is there always a balance between buyers and sellers?

No. Sometimes there are more sell orders than buy orders and vice versa. This imbalance pushes the price up and down. Occasionally, the balance gets seriously out of whack. Stock exchanges have built-in devices to try keep control when this happens.

One mechanism is the *specialist trading system*. Specialist traders have obligations to keep the market reasonably liquid for specific stocks assigned to them. For example, market orders of a specific size are guaranteed a quick execution by the responsible trader. More important, if the market is dropping because everyone wants to sell, a trader who is responsible for the stock must buy. Without this kind of arrangement, markets could grind to a halt.

Some traders have the privilege of trading *for their own (or their firm's) account*. That means they buy for the firm or sell stock that the firm owns. This adds to the market's liquidity. To ensure this is fair to the public, client orders at or better than the market price are handled before the firm's.

Besides trading, what else do stock exchanges do?

Canada's stock exchanges are Self-Regulatory Organizations. They have been given the responsibility under provincial securities law to oversee the fairness of their markets. Stock exchanges can also be held responsible for the dealings of member brokers. Stock exchanges devote a lot of resources to these regulatory responsibilities.

Why are stock exchanges changing so fast?

Because of more competition for trading and dramatic advances in technology, a large Canadian company in the 1990s does not have to list its shares for trading on a Canadian stock exchange. And even if it does, most of the trading could easily and just as quickly take place in another country. Where it trades will depend on many factors. For example, if a company has repeatedly issued shares in a foreign market, trading will move to where it's easiest for the shareholders. To keep business, a stock exchange must make sure its pricing is excellent, that information is widely available, and that it is offering the right services and products to keep customers happy.

A stock with potential to rise dramatically can also fall just as fast.

What other types of exchanges are there in Canada?

In Canada there are exchanges that trade only options, futures and future options.

The Montreal Exchange lists and trades equity, stock index and bond options, and futures and future options on stock index and debt instruments. The Winnipeg Commodity Exchange lists and trades futures and futures options on a variety of agricultural commodities like canola and flaxseed. Options give their owners the right to buy or sell the underlying asset at a set price by a certain time.

These products can have value. Think about it this way. If someone gives you a certificate that will let you buy a stock at less than what it sells for in the market on a particular day, you know that certificate is worth the difference between the two. Options are widely available on most large companies' stock.

Options help investors to hedge against market conditions. If they believe the market is going down, but are not prepared to sell the stock today, they can buy a *put* option which will allow them the right to sell the option at today's price at a future date. A *call* option, which gives the right to buy at today's price, is useful if the market moves up.

Futures are contracts that oblige the investor to buy or sell the underlying asset at a set price and time.

Futures and options are complex products and riskier than equities. You should consult carefully with your investment advisor before investing.

What causes stock prices to move up and down?

Prices move up when demand is greater than supply and down when supply is greater than demand. What causes demand to grow is harder to determine. General demand will drop if economic circumstances are unfavorable for equities. When a country is in recession, most companies' profits fall because products are not being sold. Lower profits will make the stock less attractive. Normally, too, interest rates will fall during a recession. When that happens, bond prices go up. Rising bond prices will attract investors away from the stock market which will depress demand even more.

There are lots of other factors that affect individual stock prices. Company and sector performance, management talent, international competition or trade policies, and relationships with related companies are just a few.

So how do I pick a stock that is going to go up?

That's a good question. If everyone knew the answer we'd all be rich!

Picking a good stock is not an exact science. There are lots of different systems that are used which you can discuss with your investment advisor. But keep in mind that there is always a direct relationship between risk and reward. A stock that has the potential to climb exponentially also has the potential to drop just as fast. If you can't afford or can't tolerate high risk, set your sights lower - perhaps for a stock that has nice, steady performance and regular price gains over a long time.

Before you and your advisor try to pick a winning stock that meets your objectives, look at price performance, company performance, dividend history, sector performance, and company management.

How do I find an investment advisor?

There are many ways of hearing about a good advisor. A reference from a satisfied client is effective. You should ensure the firm

is a member of a Self-Regulatory Organization in Canada which includes the stock exchanges and the Investment Dealers Association. That way you can expect a set standard of conduct rigorously applied, minimum education accreditation, and access to the industry investor protection fund.

If you don't have a reference (or even if you do), interview several firms before you select one that is interested in your account. Ask about fees and commissions and other services. Then talk to the Branch Manager to find out who would handle your account. Talk to this person, too. You want to make sure you're comfortable before you entrust your finances to that advisor.

I'm not a big investor. What will my investment advisor do for me?

Most people don't have big investment portfolios. Your advisor's job is to help you manage your assets by advising on suitable investments. Investment dealers sell a wide range of products including stocks, bonds, options, futures, and mutual funds. You will want to choose some of these for your portfolio.

Your advisor will have a good idea what is suitable for you because you will have outlined your financial objectives at the start of your relationship. An investment advisor

The more knowledge you have, the better off you'll be.

must recommend investments that are suitable for you. If you are retired and looking for income, it wouldn't be suitable for you to invest in high risk products like futures.

You will work with your investment advisor to help develop a financial plan designed to meet your objectives. As a small investor, you cannot expect your advisor to always call you with research and information. In the meantime, make an effort to follow and evaluate your investments yourself. The more knowledgeable you are, the better off you will be.

Am I really safe buying stocks? Perhaps I should stick to mutual funds.

Lots of people buy mutual funds because they are relatively easy to buy and hold. Mutual funds are pools of investments that are selected and managed professionally. The investments can range from a balanced portfolio of equity and debt, to an equity portfolio exclusively in growth stocks. Although mutual funds are not risk free, they tend to be diversified which spreads the risk considerably. They're a very good product for many people.

However, some people want to buy directly in the market. Investors like this need to understand risk. But rest assured, Canada's securities markets are not casinos! There is built-in protection in the system to help manage risk. You can find out more about this in the Investment Facts newsletter on "Investor Protection."



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