

1. Explain the relationship between earnings and a stock's market value.

Ans: As earnings, dividends, and cash flow per share increase above what was expected, investors are willing to pay more for the stock and then the stock price increases. Whereas the earnings, dividends and cash flow per share decreases beyond what was expected by the market, investors are less willing to pay for the stock, and hence the stock price declines.

High profits do not necessarily mean a high stock price, and big losses do not always lead to a low stock price. Without earnings it is hard for companies to stay in business for long. You could say that two of the major factors that influence stock price are current earnings and promise of future earnings.

- Earnings Per Share

The first step in understanding the relationship between the price of a stock and its earnings is to look at its earnings per share, or EPS. The EPS tells you how much income the company generated for each share of stock.

- Price to Earnings Ratio

The direct relationship between the price of a stock and its earnings is known as the price per earnings ratio, or P/E. To calculate P/E, simply divide the stock price by the EPS, typically over the most recent four quarters. For example, if the price of a stock is \$50 and the EPS are \$1, the P/E would be \$50. The P/E tells you how much an investor must pay to capture \$1 of earnings for a company. A high P/E means that investors are paying more to capture \$1 of earnings, but also think the company is capable of significant future growth. It is also important to note that while a company can have negative EPS, it cannot have a negative P/E. If a company has lost money, a P/E cannot be calculated.

- Impact of Earnings on Stock Price

If a company doesn't produce consistent earnings growth or lower its P/E ratio over time, investors might choose to sell the stock, sending its price lower. Young or growth-oriented companies that have extremely high P/E ratios or lose money might have a high stock price due to projected future growth. But eventually a lack of earnings over a long period of time will drive a stock price down and the company potentially out of business.

2. Which type of stock could help you obtain your investment and financial goals?

Justify your choice?

Ans: Over time, common stocks outperform all other investor investments. Stocks reduce risk through diversification and are liquid. Growth of the investments is determined by more than just interest rates. Basic common stock has limited liability as a shareholder you are a part owner but if the company broke down, you can only lose the amount you invested. You have a right to earnings of the company after all other obligations are met. Dividends are declared and then paid quarterly if any earnings remain. Over the long term, common stock, by means of capital growth, has tended to yield higher returns than corporate bonds. This higher return comes at a cost, however, since common stocks entail the most risk including the potential to lose the entire

amount invested if a company goes out of business. If a company goes bankrupt and liquidates, the common shareholders will not receive money until the creditors, bondholders and preferred shareholders are paid. Common stockholders can claim their assets only after debtors and preferred stockholders have been paid. As a common shareholder you have the right to vote because of the large number of shareholders this right is normally executed through a proxy which is an agreement allowing a designated party to vote your shares.

The general classifications of the common stocks are Blue-chip stocks, Growth stocks, Income stocks, Speculative stocks, Cyclical stocks, Defensive stocks, Large-caps, Mid-caps, and Small-caps.

- Blue-Chip stocks issued by large well-known companies. Normally have sound financial histories, solid dividend, and growth records for example General Electric, Texaco, and Protector Gamble. Blue Chip is a stock recognized for features such as stable earnings, high quality, less volatility and good returns. A regular investor with limited financial literacy can be amazed by the number of options to invest while looking at all the listed stocks on an exchange.
- Growth stocks are shares in a company whose earnings are expected to grow at an above-average rate relative to the market and its sales and earnings growth have outpaced the market. A growth stock usually does not pay a dividend, as the company would prefer to reinvest retained earnings in capital projects. Growth investors choose stocks based on the potential for capital gains, not dividend income, so they can be risky. For example, Microsoft. A growth company typically has some sort of competitive advantage (a new product, a breakthrough patent, overseas expansion) that allows it to fend off competitors. Growth stocks usually pay smaller dividends, as the company typically re-invests retained earnings in capital projects.
- Income stocks issued by mature firms that normally pays high dividends and usually have low growth rates. Income stocks tend to be among the least volatile of all stocks, and many investors view them as defensive stocks. *Defensive stocks* are stocks of companies that sell goods and services that are generally needed no matter what shape the economy is in. Food, beverage, and utility companies are great examples of defensive stocks. Even when the economy is experiencing tough times, people still need to eat, drink, and turn on the lights. Companies that offer relatively high dividends also tend to be large firms in established, stable industries.
- Speculative stocks issued by higher risk companies and generally sold on the OTC market and difficult to forecast future earnings. Some are associated with the astronomical gains and losses. These stocks can generate "enormous gains" when done correctly, but they can also bring "gut-wrenching losses" when mistakes are made. There are two kinds of stocks in the single-digit space: Those that have been shunned by institutional money managers and the relatively unknown stocks of undiscovered companies. Money managers fear the downside of stocks that appear broken, so they will not invest in single-digit stocks. When it comes to speculative stocks, Cramer said the

overall goal is to invest in tiny, largely unknown companies in sectors that could catch a turnaround. These speculative fads happen quickly and don't often last long, so it's important to take profits when you have them. At the same rate, it is wise to cut your losses before you get burned. When you speculate, you don't want to buy and hold forever. Instead, investors should look for something that's going higher and when it does.

- Cyclical stocks tend to be highly correlated with the overall business cycle, so an investor can invest in a cyclical stock and capture gains during upward movements in the business cycle. For example, Ford and General motors. An investor can combine cyclical stocks and non-cyclical stocks to create a diversified portfolio that protects him from volatility. If an investor can invest in a cyclical stock at the bottom of the business cycle and subsequently sell the stock at the top of the business cycle, he maximizes capital gains for that stock over that period. This is a huge benefit.
- A defensive stock issued by the companies whose earnings tend to move inversely to the broader economy and may actually increase during economic downturns. For example manufacturers or seller of repairs parts. The share prices of defensive stocks tend to hold up better during periods of economic uncertainty and financial market turbulence. On the other hand, companies in defensive sectors often carry higher amounts of debt, in which case their share prices or dividends might be negatively affected by a rise in interest rates.
- Large-Caps, Mid-Caps, and Small-Caps that refer to the level of capitalization or the market value, and the size of the firm. Smaller companies tend to have a greater chance of large growth, faster. small cap companies have the ability to outperform large cap companies. This doesn't come without risk, though. while investing in a small-cap ETF or mutual fund can be riskier than investing in a large-cap fund, it's a necessary element in a diversified portfolio. Remember, rewards don't come without risks in investing. It's important to know the difference between ETFs and mutual funds, as well as their strategies, before investing. Also, understanding market capitalization is crucial before choosing your own investment strategy. You also want to make sure you're comfortable with your asset allocation so you're not too heavily weighted in one asset class. This will help you keep a well-balanced and diversified portfolio.

3. What sources of information would you use to evaluate a stock issue?

Ans: Most of the common measuring stocks are easily available online or in the print and online versions of The Wall Street Journal.

The most basic measure of a stock's worth involves that company's earnings. When you buy a stock, you're acquiring a piece of the company, so profitability is an important consideration. The business can pay you for your ownership stake in several ways. It can give you a portion of the profits which for shareholders comes in the form of a periodic dividend. It can continue to expand the business, reinvesting money earned to increase profitability and raise the overall value of the business. In such cases, a more valuable business makes each piece, or share, of the business more valuable. In such a scenario, the more valuable share merits a higher price, giving the share's owner capital appreciation, also known as a rising stock price.

Not every company pays a dividend. In fact, many fast-growing companies prefer to reinvest their cash rather than pay a dividend. Large, steadier companies are more likely to pay a dividend than are their smaller, more volatile counterparts.

The most common measure for stocks is the price to earnings ratio, known as the P/E. This measure, available in stock tables, takes the share price and divides it by a company's annual net income. As a general rule of thumb, stocks with P/Es higher than the broader market P/E are considered expensive, while stocks with a below-market P/E are considered cheaper.

But P/Es are not still a perfect measure. A company that is small and growing fast may have a very high P/E, because it may earn little but has a high stock price. If the company can maintain a strong growth rate and rapidly increase its earnings, a stock that looks expensive on a P/E basis can quickly seem like a bargain. Conversely, a company may have a low P/E because its stock has been slammed in anticipation of poor future earnings. Thus, what looks like a "cheap" stock may be cheap because most people have decided that it's a bad investment. Such a temptingly low P/E related to a bad company is called a value trap.

Other popular measures include the dividend yield, price-to-book and, sometimes, price-to-sales. These are simple ratios that examine the stock price against the second figure, and these measures can also be easily found by studying stock tables.

Investors seek better value seek out stocks paying higher yields than the overall market, but there is just one consideration for an investor when deciding whether or not to purchase a stock.

Picking stocks is more like evaluating any business or company you might consider buying. After all, when you buy a stock, you're essentially purchasing a stake in a business.

4. What is the difference between the primary market and the secondary market?

Ans: The difference between the primary capital market and the secondary capital market is that in the primary market, investors buy securities directly from the company issuing them, while in the secondary market, investors trade securities among themselves, and the company with the security being traded does not participate in the transaction.

When a company publicly sells new stocks and bonds for the first time, it does so on the primary capital market. In many cases, this takes the form of an initial public offering. When investors purchase securities on the primary capital market, the company offering the securities has already hired an underwriting firm to review the offering and created a prospectus outlining the price and other details of the securities to be issued.

Companies issue securities via the primary capital market hire investment bankers to obtain commitments from large institutional investors to purchase the securities when first offered. Small investors are not often able to purchase securities at this point, because the company and its investment bankers seek to sell all of the available securities in a short period of time to meet the required volume and must focus on marketing the sale to large investors who can buy more securities at once.

The secondary market is where securities are traded after the company has sold all the stocks and bonds offered on the primary market. Markets such as the New York Stock Exchange, London Stock Exchange or Nasdaq are secondary markets. On the secondary market, small investors have a better chance of buying or selling securities, because they are no longer excluded from IPOs due to the small amount of money they represent. Anyone can purchase securities on the secondary market as long as they are willing to pay the price for which the security is being traded.

On the secondary market, an investor requires a broker to purchase the securities on his or her behalf. The price of the security fluctuates with the market, and the cost to the investor includes the commission paid to the broker. The volume of securities sold also varies from day to day, as demand for the security fluctuates. The price paid by the investor is no longer directly related to the initial price of the security as determined by the first issuance, and the company that issued the security is not a party to any sale between two investors. However, the company can engage in a stock buyback on the secondary market.

5. Calculating Total Return. Tammy Jackson purchased 100 shares of All-American Manufacturing Company stock at \$31.50 a share. One year later, she sold the stock for \$38 a share. She paid her broker a \$28 commission when she purchased the stock and a \$42 commission when she sold it. During the 12 months that she owned the stock, she received \$160 in dividends. Calculate Ms. Jackson's total return on this investment.

Ans: Given, Current Return = \$160 in dividends over the past 12 months

$$\begin{aligned} \text{Purchase Price} &= \$31.50 \times 100 \text{ shares} + \$28 \text{ commission} \\ &= \$3,178 \end{aligned}$$

$$\begin{aligned}\text{Selling Price} &= \$38 (100 \text{ shares}) - \$42 (\text{commission}) \\ &= \$3,758\end{aligned}$$

$$\text{Capital gain} = \$3,758 - \$3,178 = \$580$$

$$\begin{aligned}\text{Total Return} &= \text{Current Return} + \text{capital gain} . \\ &= \$160 + \$580 \\ &= \$740\end{aligned}$$