UNIT 2: Introduction to Financial Markets

TEACHING STANDARDS / KEY TERMS

- ✦ 12(b)-1 fees
- ✦ "Blue chip" companies
- ✦ Bond market
- ✦ Caveat emptor
- ✦ Commodity Futures Trading Commission (CFTC)
- ✦ Common vs. preferred stock
- ✦ Consumer
- ✦ Coupon rate
- ✦ Dividend
- ✦ Dollar cost averaging
- ✦ Dow Jones Industrial Average (DJIA)
- ✦ Economic growth
- ✦ Economic indicators
- ✦ Economy
- ✦ Exchange
- ✦ Financial markets
- ✦ Free enterprise system
- ✦ Futures
- ✦ Gross domestic product
- ✦ Load vs. no-load
- ✦ Market economy
- ✦ Markets
- ✦ Mutual funds
- ✦ NASDAQ Stock Market

- Net Asset Value (NAV)
- New York Stock Exchange (NYSE)
- National Association of Securities Dealers (NASD)
- Private vs. public companies
- Prospectus
- Risk tolerance
- Securities and Exchange Commission (SEC)
- State securities regulators
- Stock
- Stock market
- Supply vs. demand

UNIT OBJECTIVES:

Students will:

- Understand the relationship between risk and reward.
- Learn about U.S. financial markets and investment products.
- Explore conditions that affect market prices.
- Grasp the extent and limits of government regulation of the financial markets.

UNIT TEACHING AIDS:

LESSON 1: Myths Vs. Realities: Risk and Returns *(Handout/Overhead, page 2.17)*

LESSON 2: Market Questionnaire *(Worksheet, page 2.20)*
Company Questionnaire *(Worksheet, page 2.22)*

LESSON 3: Reading Stock Tables *(Handout, page 2.23)*
Evaluating Stock Prices *(Worksheet, page 2.26)*

LESSON 4: Securities Regulation Research Project *(Worksheet, page 2.28)*

UNIT TEST: *(Test page 2.29 and page 2.30; Answer Key, page 2.31)*

Why Teach This Unit?

The high school student of today is the investor of tomorrow... or should be. It is important, therefore, that students gain a basic understanding of how the financial markets function. This Unit is designed to help take the mystery out of the financial marketplace by demonstrating its strong presence in students' everyday lives and by providing a basic understanding of how financial markets work.

Students do not have to be rich to start investing. Today, more than half of all American adults are investors. Very few of these people are financial geniuses driving fancy cars and living in mansions. Instead, the vast majority of today's investors are teachers, doctors, carpenters, government employees, lawyers, and so on. Many started out investing very modest amounts of money—as little as $25 or $50 a month.

The financial markets will play a major role in the life of today's high school student. How much will gasoline cost? How high will the interest be on your first home? Will your job be outsourced to another nation in a global economy where companies seek to maintain the lowest costs? Market forces already affect daily life in many ways and will become only more pronounced in the future. So, even if a student is not going to be an active investor, he or she will need to understand the financial markets.

LESSON 1: UNDERSTANDING RISK AND RETURN

Investors run the ***risk*** of losing their money when they invest, but they stand to gain a ***return***—more money—if the investment is profitable. The rule of thumb of the investing world is as follows: The bigger the risk, the bigger the potential payoff.

We learned in Unit 1 that "risk" is the chance one takes that an investment will lose money or earn less than it might otherwise earn. It follows that **"risk tolerance"** is how much risk an individual can afford to take—each person's ability to ride out the ups and downs of the market and the potential of losing what they have invested. Risk tolerances vary from person to person and at different stages in the life cycle. Young adults who invest can withstand market fluctuations to see their investments increase in value over the years and can afford to take greater investment risks than people who are approaching retirement.

People who can't afford to lose the principal of their investment should select savings and investments with less risk. On the other hand, investments that guarantee the safety of principal may not maintain purchasing power in times of high inflation.

Students should learn the six major types of investment risk:

- **Interest rate risk** is the risk that the value of an investment will decrease due to a rise in interest rates. The value of a fixed-return investment decreases when interest rates increase and increases when interest rates go down.
- **Business failure risk** is the risk that the business will fail and the investment will be worthless or that the business will be less profitable than expected. How well will the business do in both good and bad economic times?
- **Market price risk** is the risk that the price of an investment will go down. Many factors influence whether the price of an investment will go up or down. Few investors can consistently predict the ups and downs of the market. Investors may experience a loss if they must sell when the market price is down.
- **Inflation risk** is the risk that the financial return on an investment will lose purchasing power due to a general rise in prices of goods and services. Investment returns must be more than what the rate of inflation is in order to truly increase in value.
- **Political risk** is the risk that government actions such as trade restrictions or increased taxes will negatively affect business profits and investment returns.
- **Fraud risk** is the risk that the investment is designed to deceive and misrepresent facts. In every case of investment fraud, the seller wins while the investor loses.

LESSON 2: HOW FINANCIAL MARKETS WORK

Markets are the meeting place where buyers and sellers come together and determine prices. A **financial market** is a place where firms and individuals enter into contracts to buy or sell a specific product such as a stock, bond, or futures contract. Buyers seek to buy at the lowest possible price and sellers seek to sell at the highest possible price. The market for stocks and other investments is similar in concept to a farmer's market where growers display their produce for consumers to buy. Financial markets are where money and people come together with the vibrant energy of free enterprise.

Supply and Demand

In this teaching guide, the focus is on **market economies**—economic systems in which individuals own and operate businesses. All markets comprise two basic participants: the buyer and the seller. In a financial market, the buyer is the investor. The investor may be an individual, organization, or company. A buyer or investor may also be referred to as a **consumer**—one who buys or uses products or resources. The seller is the entity offering the product and may be an individual, company, government agency, or other organization.

Prices for goods or services in any market depend largely on the supply and demand of the product or service. **Demand** is the quantity of goods that consumers purchase in a given time period. The

law of demand suggests that the demand for a product and the cost of that product have an inverse relationship. **Supply** is the amount of products or services that a producer is able to make available to consumers at a given time. The **law of supply** suggests that as a product's cost increases, the quantity supplied to buyers also tends to rise. If the supply of a product is insufficient to meet the demand, consumers will pay more. On the other hand, if the supply outweighs the demand, the price will remain low. Discuss with your students some current examples of consumers paying more or less because of an imbalance of supply and demand.

An auction is an excellent place to study the effects of supply and demand. In an auction (traditional or Internet-based), goods are sold at the highest offered price. Thus, the relationship between supply and demand is obvious. Consider the following example:

Anthony, who is taking an economics class, and his family attend an auction near their home each month. A discussion in his class about supply and demand, prompted Anthony to apply what he had learned about the subject at the next auction. In the first hour, a very old piano sold for $2,000, while a much newer one sold for only $150. Why the difference in price? Several people wanted the older piano, but since only one was available for purchase, the potential buyers pushed the price up until only one remained when the bidding reached $2,000. In contrast, several newer pianos were available; however, only one person was interested in purchasing it so the price remained low.

Students can see the direct impact of the laws of supply and demand by going to an Internet site such as eBay **(http://www.ebay.com).**

What Is an Exchange?

The financial markets in the United States operate under the same basic economic rules as all other markets. Financial markets are made up of a number of different "exchanges," which serve as central locations where buyers and sellers meet in person, by telephone, or by computer terminal to trade stocks, bonds, commodities, options, future contracts, and other securities. An ***exchange*** may be an actual building or a network of computers that serve as a central location where people buy and sell financial products.

Public corporations list their stocks and bonds on an exchange. These listings draw a steady pool of interested buyers and sellers, or investors. Just as a newspaper doesn't own the goods or provide the services it advertises, a stock exchange doesn't own the stocks and bonds it lists.

Today, several exchanges make up what is known as the **stock market** (or the financial markets). However, most stocks in the United States are listed (traded) on these two exchanges: the **New York Stock Exchange (NYSE)** and the **NASDAQ Stock Market.** The NASDAQ is a computer-based trading system, while the NYSE is floor based. A traditional floor-based market operates in a specific building where the investor's agent must be present to trade stocks. To purchase company stock listed on the NYSE, the investor places an order through a stockbroker. The stockbroker relays the purchase to a floor trader who is on the exchange floor. The floor trader then purchases the stock.

A computer-based market, such as the NASDAQ, enables investors to trade stocks through a telecommunications network; they access the market on desktop terminals anywhere they happen to be while a mainframe computer processes the trade.

The vast majority of businesses in this country are private. **Private companies** are owned solely by an individual, a family, or a small group of people, and do not have stocks that are traded on exchanges. Private companies are on every main street in every town and scattered throughout the cities of America. Barbershops, hair salons, bicycle stores, bowling alleys, video arcades, restaurants, candy stores, and other neighborhood shops are just some examples.

Conversely, **publicly-traded companies** are those that offer shares of stock, or partial ownership, to those who wish to buy into that company.

The Markets Meet the Web

The Internet and other new technologies are in many ways transforming how our markets operate. There are clear benefits to these changes, including lower costs and faster access to the markets for investors. The Internet is also used to educate many first-time investors about the basics of investing. It is essential for investors to understand that stock market investing always involves risk. Whether investing online or through more traditional means, consumers must know the following information:

- ✦ The investments being purchased.
- ✦ The ground rules under which the stock or bond is being bought or sold.
- ✦ The level of risk involved with the investment products.

Online investors should remember that it is just as easy (if not easier) to lose money as it is to make money through the click of a button. Every prospective investor needs to know the risks unique to investing online. For example, stock prices can move quickly, so when many investors attempt to purchase (or sell) the same stock at the same time, it affects the price immediately. Just seeing a price on the computer screen doesn't mean the investor always will be able to get that price.

More information about online investing may be found at **http://www.investingonline.org**.

LESSON 3: SAVINGS, STOCKS, BONDS, MUTUAL FUNDS AND OTHER INVESTMENTS

What is Saving?

The rates of return and risk for **saving** at a bank are usually lower than other forms of investment. Interest-bearing checking and savings accounts are offered by banks, credit unions, and savings and loan institutions. It pays to shop for the best rates, as interest rates, compounding frequencies and services vary widely among financial institutions.

If the financial institution where an individual has a checking or savings account is insured by a fund of the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA), that account is insured up to $100,000 by the federal government against failure of the financial institutions.

Certificates of deposit, often referred to as "CDs", are purchased for specific amounts of money at a fixed rate of interest for a specified period of time. CDs may be purchased for as little as $500 but generally are priced at $1,000, $5,000, or $10,000. An individual may buy a CD for as little as seven days or for as long as several years. The longer the timeframe, the higher the interest rate. CDs cashed in before the maturity date incur interest penalties. CDs are insured if the financial institution where they are purchased is a member of the FDIC.

Many savers also consider U.S. Treasury securities including Treasury bills, notes and bonds. These can be purchased through financial institutions for a fee or at a branch of the Federal Reserve Bank with no added cost. T-bills have a face value of $10,000; Treasury bonds, $1,000.

What is a stock?

A **stock** is an investment product that represents partial ownership of a company or corporation. The stock market represents all the companies that sell their shares to the public. It is the primary place for companies to obtain financing for their operations and for investors to profit on the growth of those companies. There is therefore a close relationship between the stock market and the economy as a whole.

Thousands of companies in the United States, known as **public companies**, invite students, their parents, relatives and neighbors to become part owners. They do this by selling shares of the company. When an investor buys a share of a company, he or she receives a stock certificate or additional documentation that proves stock ownership. If stock shares are purchased through a brokerage firm, the broker holds the stocks in "street name," which means the brokerage firm maintains the paperwork that proves stock ownership.

It has been said that when it comes to ownership, a public company is the most democratic institution in the world. It is an example of true opportunity. Investing in public companies is the way many people can participate in the growth and prosperity of a company. Selling stock also benefits the company. When a company sells shares, it uses the money to open new stores, build new factories, or upgrade its merchandise so it can sell more products to more customers and increase its profits. As the company becomes larger and more prosperous, its shares become more valuable. There is no guarantee, however, that a publicly-traded company will be successful. A company with a great deal of money raised from the public can suffer serious setbacks or even be forced to close its doors because of a variety of factors.

There are two types of stock shares: **common** and **preferred:**

- When investors own a public company's **common stock**, they are entitled to vote in the election of company officers as well as other important matters, and they often receive dividends on their shares. Since common stock is often riskier than preferred stock, it offers greater potential returns and losses.

- Shareholders of **preferred stock** would not usually have voting rights, but would receive a fixed dividend, or share of a company's profits, which is paid to preferred stockholders before common stockholders are paid. However, owners of preferred stock pay for that privilege—usually their dividends wouldn't increase when the company's profits increase. When a company does well, the price of its preferred stock tends to under-perform the common shares. However, when a company fails, its preferred stockholders recoup their investment before common stockholders (assuming they can recoup anything at all).

The stock **price** is the amount an investor pays for one share of a public company's stock at a given moment. Outside events can make the price of a stock rise or fall. For instance, if another company or a big investor wants to buy that company, the share price could rise quickly based on that news. On the other hand, if an investor owns stock in a pharmaceutical company and its competitor wins government approval for a drug similar to one that the shareholder's company manufactures, the company's stock price might tumble. Other forces that can affect stock prices include interest rates, national and international issues or events, foreign exchange rates, financial forecasts, and new technologies. Retail stocks, for example, are subject to declines during recessions.

Dividends are the distribution of a company's profit or earnings to the company's shareholders or stockholders—the people and firms that have purchased that company's stock. Dividends are another way that you can share in a company's growth; they are usually distributed quarterly. Most companies offer a **dividend reinvestment plan**, which means that instead of paying you by check or depositing the money into your account, the amount of the dividend is used to buy more shares of the company's stock in your name. This is a good way to increase your investment in the company over time.

There are different kinds of stocks:

- The terms **large-cap**, **mid-cap**, and **small-cap** refer to the issuing company's **market capitalization**, that is, the overall value of all shares of the company's stock.

- **Growth stocks** are shares of companies exhibiting relatively fast growth in earnings, which generally causes the stock price to go up. Be certain your students understand that growth stocks are the most volatile and can fluctuate rapidly because growth companies are typically in new, or fast-growing, industries such as the high-tech sector. Growth stocks are considered riskier and often pay lower or no dividends, but appeal to investors who will accept more volatility and risk in hopes of greater appreciation in share price over time.

- **Income stocks**, on the other hand, are characterized as those that would pay high and regular dividends. Stable and well-established industries, including utilities and financial institutions, typically produce income stocks.

- **Blue chip** is the name applied to the stock of large, well-known, well-established companies with good reputations.

- **Value stocks** are those considered to be selling at lower prices or "undervalued" because the companies that issue these shares have had business setbacks or are out of favor with investors. Value stocks have been known to outperform growth stocks in slow markets—and vice versa. But there is still a risk with value stocks because not all companies recover from setbacks.

Note: Stocks are often referred to by a combination of the characteristics discussed above, such as shares of a "small-cap value" stock or of a "mid-cap growth" stock.

Students can learn more about investing in individual stocks by visiting such Web sites as Valueline (**http://www.valueline.com**) and the Motley Fool (**http://www.fool.com**). Remind your students to make up their own minds about investing based on what makes sense for them—not solely on the opinion of someone else.

(To help your students have a better understanding of how to read the stock tables in the newspapers, go to the handout on page 2.23.)

What are Bonds?

When investors buy **bonds**, it means they have loaned money to a company or a governmental entity. In return, that company or governmental entity promises to repay the amount borrowed plus interest. Corporate bonds are issued by publicly-owned companies, while municipal bonds are issued by state or local governments.

The price of a bond will fluctuate with interest rates. When interest rates go up, prices of currently trading bonds tend to go down, and vice versa. If the bond is held to maturity, the investor will receive an amount stated on the bond known as the **face value**. For example, if a student buys five corporate bonds at $1,000 each and the bonds mature in 20 years, even if the value of the bond changes over the period of time they are held, the bonds will be worth a total of $5,000 at the time of maturity. In addition, the borrower may promise to pay you an interest payment twice a year for 20 years. The declared interest of the bond is called the **coupon rate**.

As The Bond Market Association notes, bond investors may take advantage of several different marketplaces:

- **Municipal Securities Market.** Municipal securities are a primary way that U.S., state and local governments borrow money to finance their capital investment and cash flow needs. States, cities, counties, and other governmental entities use municipal bonds to raise money to build schools, highways, hospitals, and sewer systems, as well as many other projects for the public good. An important distinguishing characteristic of the municipal securities market is the exemption of interest on municipal bonds from federal income taxes.

- **Treasury Securities Market.** The U.S. Treasury securities market is the largest and most liquid financial market in the world. The U.S. Treasury issues three types of securities: bills, which have a maturity of less than 1 year; notes, which have a maturity of 2 to 10 years; and bonds, which have a maturity of greater than 10 years.

- **Federal Agency Securities Market.** Federal agency debt is issued by various government-sponsored enterprises (GSEs) created by Congress to fund loans to borrowers such as homeowners, farmers and students. Among the most active issuers of agency debt securities are: Federal Farm Credit System Banks, Federal Home Loan Banks, Federal Home Loan Mortgage Corporation (Freddie Mac), Federal National Mortgage Association (Fannie Mae), Student Loan Marketing Association (Sallie Mae) and Tennessee Valley Authority (TVA).

- **Corporate Bond Market.** Corporate debt securities are obligations issued by corporations for capital and operating cash flow purposes. Corporate debt is issued by a wide variety of corporations involved in the financial, industrial, and service-related industries.

- **Mortgage Securities Market.** Mortgage securities represent an ownership interest in mortgage loans made by financial institutions (savings and loans, commercial banks, or mortgage companies) to finance the borrower's purchase of a home or other real estate. Mortgage securities are created when these loans are packaged, or "pooled", by issuers or servicers for sale to investors. As the underlying mortgage loans are paid off by the homeowners, the investors receive payments of interest and principal. The majority of mortgage securities are issued and/or guaranteed by an agency of the U.S. Government, the Government National Mortgage Association (Ginnie Mae), or by government-sponsored enterprises such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

Most individual bonds are bought and sold in the over-the-counter (OTC) market, although some corporate bonds are also listed on the New York Stock Exchange. To purchase a new bond issue, a financial professional will provide the bond's offering statement—the prospectus. It will spell out a bond's key terms and features, as well as the risks involved.

Investors can also buy and sell bonds that have already been issued. This is known as the **secondary market**. Many dealers keep inventories of a variety of outstanding (i.e., previously issued) bonds. Bonds sold in the over-the-counter market are usually sold in $5,000 denominations. In the secondary market for outstanding bonds, prices are quoted as if the bond were traded in $100 increments. Thus, a bond quoted at 98 refers to a bond that is priced at $98 per $100 of face value, or at a 2 percent discount. Students can learn more about how bond market investing works at **http://www.investinginbonds.com**.

What is a Mutual Fund?

A **mutual fund** invests the pooled money of its shareholders in various types of investments. The fund manager buys and sells securities for the fund's shareholders. Mutual funds are not risk free. Their values rise and fall along with the securities in the fund. The shares in a mutual fund are priced by dividing the current market value of investments owned by the mutual fund by the number of mutual fund shares. As the value of the securities in the fund goes up or down, the value of each share changes accordingly.

Benefits of mutual funds for the beginning investor include:

- ✦ Diversification
- ✦ Professional management
- ✦ Often low-cost shares
- ✦ Liquidity (shares can be bought and sold easily)

More than 8,000 different mutual funds are available on the open market. The investor should learn the objective of the fund, what securities the fund owns, the level of risk, and its earnings record as compared with similar funds. Each mutual fund has an objective that determines the types of securities in which it invests. The fund objectives are stated clearly in the **prospectus**, which is the legal document describing the fund. For example, the fund objective may be "growth and income." This growth and income fund might own common stock of emerging companies and common and preferred stocks and bonds of large, well-known "blue-chip" companies. The prospectus is available online or by mail from the investment company that manages your mutual fund.

Most mutual funds require a minimum initial investment, sometimes as low as $250, but often quite a bit higher. Mutual fund shares trade very much like stocks, rising and falling in price depending on investor interest and the performance of stocks in the fund. **The Net Asset Value (NAV)** of a mutual fund indicates its value or price per share. Like stocks, mutual funds are liquid, which means they can be easily bought and sold.

The two most common types of mutual funds are **equity funds** that invest primarily in common stocks and **fixed-income funds or "bond funds"** that typically invest in bonds or money market securities. Investors can find a hybrid in **"balanced funds"** that invest in both equities and bonds.

Before investing in a mutual fund, explain to students that they need to find out if it's a load or no-load mutual fund. **Load funds** charge a sales commission; no-load funds don't. When a sales commission is paid going into a mutual fund, that's called a **front-end load**. A commission paid when you sell is known as a **back-end load**.

In theory, the advantage to "paying a load" for a fund is that there are usually staff members available to explain the fund to potential investors and advise them as to the appropriate time to buy more shares, or to sell. For new investors, like your students, it might be worth paying the commission for the extra guidance. With some **no-load funds**, an employee merely takes your order to buy or sell, or can only offer limited support—the investor is fully responsible for understanding the investment. Even a no-load fund may still charge a **"12(b)-1 fee"** to cover the sales and marketing expenses involved in operating the fund.

One of the best resources for students who want to learn more about investing in mutual funds is available at Morningstar **(http://www.morningstar.com)**.

Note: One key wealth-building strategy for mutual fund investors is **"dollar cost averaging"**—the technique of investing the same fixed dollar amount in an investment, such as a mutual fund, at regular intervals over a long period of time. The advantage of dollar cost averaging is that the average price per share will be lower because the cost is spread out over time, providing insulation against changes in market price. When employees purchase shares of their employer's stock through regular payroll deductions, they are dollar cost averaging.

Dollar cost averaging helps avoid the problem of buying high and selling low. Investors can make money if they sell the investment at a price higher than the average purchase price over the time that they invested. This can help limit losses during times of declining prices and accelerate profits during times of rising prices.

What are Futures?

A futures contract is a commitment to buy or sell a specific amount of a commodity at a specific future date and price. Futures contracts deal in products ranging from corn, soybeans, wheat and cattle to gold, crude oil, Japanese yen, and U.S. Treasury bonds.

The concept of hedging in the futures marketplace is simple. By buying or selling in the futures market now, individuals and firms are able to establish a known price level for something they intend to buy or sell later. Buyers are thus able to protect themselves against—that is, to hedge against—higher prices while sellers are able to hedge against lower prices. Investors do not actually intend to buy the product in question (e.g., orange juice or hog's bellies); they are in the futures marketplace to speculate on future price movements.

Investors who trade in futures contracts or options, either for speculation or price risk management, have their orders to buy or sell communicated through a brokerage firm to the trading floor for execution by a floor broker. If a buyer, the broker will seek a seller at the lowest available price. If a seller, the broker will seek a buyer at the highest available price. That's what the shouting and signaling is about in a futures exchange.

As this explanation suggests, futures are a speculative investment suited only for knowledgeable investors who are willing to take high risk. Futures investors have to be prepared to lose all of their investment—and even more.

Moving Markets

The relationship between a business and a consumer is this: If a business has something the consumer wants and the consumer has the money to buy it, a sale will be generated and the business will profit from that sale. The leading **economic indicators** reported on the news are nothing more than measurements of the buying and selling activities of companies and the spending or saving activities of individuals on a national or international scale.

The stock market is not only affected by these indicators, but is also considered an economic indicator in its own right. The stock market is a primary barometer of the economic health of a nation and a part of the economy most sensitive to what is happening in all other areas. This is because consumer and industrial spending activities drive corporate earnings, which, in turn, drive stock prices.

In any given period, the stock market will rise and fall. Each time it rises or falls, individual stock prices are affected. When a stock rises and falls more than the average stock price, it is considered volatile. During times that stock markets rise, the country is generally experiencing a period of **economic growth**. Economic growth is marked by an increase in jobs, income levels, and goods and services produced and sold.

Experts cannot tell exactly what will happen to a stock or bond's value because many factors affect these changes. Five main factors follow:

- **Investor Actions.** Individual investors, institutional investors (organizations that buy and sell high quantities of securities and have sizable portfolios) and mutual fund managers all affect the price of securities by their actions in buying or selling. For example, when large numbers of individual investors invest in the stock market on the basis of encouraging economic news, the overall market can rise, which, in turn, may "lift" the price of individual stocks.

- **Business conditions.** Profits, volume of sales, and expansion of a corporation's plants all affect investor interest and, consequently, stock prices. Health of the economy, business conditions in general, and the business cycle (i.e., the normal times of high and low sales during the year) also affect stock prices.

- **Government actions.** Government decisions regarding issues such as interest rates, taxes, trade policy, and budget deficits affect stock prices.

- **Economic indicators.** Published measurements of the buying and selling activities of companies and the spending and saving activities of individuals—including measurements of personal income levels, employment, consumer spending patterns, business inventories, and interest rates—affect various industries and subsequently stock, bond, and futures prices. The **gross domestic product** is a key indicator that is calculated by the U.S. Department of Commerce four times a year. It measures the value of goods and services produced throughout the nation in a given quarter.

- **International events and conditions.** Events around the world, such as changes in the currency exchange rates, trade barriers and restrictions, wars, natural disasters, and civil strife also affect stock prices.

When following a stock, it is helpful to graph its closing price on a regular basis. Students need to know the stock symbol or stock abbreviation, what exchange the stock is listed on, and the column in the newspaper where the closing price is quoted. Students may call the company and ask for the symbol and the exchange in which the stock is listed. In the financial section of the newspaper, students can find that exchange, and then look for the stock symbol. After finding the stock symbol, they should look under the column that lists the closing price. In the Wall Street Journal, the closing price is the second to last column, however, stock tables vary from newspaper to newspaper. Have your students locate the closing price and record it on graph paper with the closing price on the Y-axis and the day on the X-axis.

LESSON 4: REGULATION OF FINANCIAL MARKETS

The government plays an important role in the licensing and registration of investment professionals and the financial products they sell. With all this regulation, however, it is still the investor's responsibility to make wise choices about the professionals with whom they work and the products in which they invest. Students should always heed the advice **caveat emptor**, which means "let the buyer beware." Understanding the basics of state, federal, and industry oversight will help students know the extent and limits of consumer protection by these entities.

The Role of the States

State securities regulators have protected investors from fraud for nearly 100 years. Securities markets are global; however, securities are sold locally by professionals who are licensed in every state where they conduct business. State securities regulators work within your state government to protect investors and help maintain the integrity of the securities industry.

A state securities regulator can: verify that a broker-dealer or investment adviser is properly licensed; provide information about a financial professional's educational background, work history, as well as prior run-ins with regulators that led to disciplinary or enforcement actions; provide a computer link or telephone number or address where you can file a complaint. Depending on the size of the investment advisory firm, some will register with state securities regulators and others with the federal government.

For contact information for your State securities regulator, visit the North American Securities Administrators Association (NASAA) Web site at **http://www.nasaa.org** and click on "Contact Your Regulator."

The Role of the Federal Government

Federal securities regulation focuses on the broader issue of how the stock market works on a national and international basis. Important federal securities laws were enacted in the early 1930s. A major impetus behind these new laws was the stock market crash of 1929 and the abusive practices that led to the crash. The *Securities Act of 1933* is known as the "truth in securities" law and has two objectives: to require that investors be provided with information concerning securities offered for public sale; and to prevent misrepresentation, deceit, and other fraud in the sale of securities. As a result of this law, securities must be registered with the Securities and Exchange Commission (SEC). Registration is intended to provide adequate and accurate disclosure of facts concerning the company and the securities it proposes to sell.

Registration of securities does not prevent the sale of stock in risky, poorly managed or unprofitable companies. Nor does the SEC approve or disapprove securities based on their investment quality. While the *Securities Act of 1933* offers some consumer protection, the burden of making sound investment choices remains with the investor. The *Securities Exchange Act of 1934* created the Securities and Exchange Commission and spells out the SEC's licensing and regulatory duties. Their power extends to the over-the-counter markets as well as the stock exchanges.

The *Security Investors Protection Act of 1970* established the Security Investors Protection Corporation (SIPC), which is similar in its operation to the Federal Deposit Insurance Corporation that insures deposits in financial institutions. The SIPC statute provides for the return of certain customer assets in the event of financial failure of a brokerage firm that is an SIPC member. However, SIPC provides no protection for a decline in the value of securities as a result of economic conditions or fraud.

The Commodity Futures Trading Commission (CFTC) is an agency of the federal government that is similar to the SEC. It regulates futures contracts and the trading of commodities on boards of trade, which are similar to stock exchanges.

Self-Regulatory Organizations (SROs)

The SEC delegates significant regulatory authority to a number of self-regulatory organizations (SROs). These SROs include the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), a number of regional stock exchanges, and five options exchanges. The SEC oversees the SROs using the authority it has been granted by the U.S. Congress. All SRO rules and regulations must be approved by the SEC before they can take effect.

Self-regulatory organizations (SROs) are bodies that provide a means for the equities and futures industries to assume part of the responsibility of policing themselves. The two main SROs are the National Association of Securities Dealers (NASD) and National Futures Association (NFA), which are monitored by the SEC and the CFTC, respectively. Among the responsibilities of the SROs are to:

- ✦ Establish rules governing trading and other activities.
- ✦ Set qualifications for industry professionals.
- ✦ Oversee the conduct of their members.
- ✦ Impose discipline in instances of unethical or illegal behavior.
- ✦ Administer the licensing process, including background investigations and licensing examinations.

FINANCIAL/INVESTMENT PLANNING: MYTH VS. REALITY

MYTH	REALITY
If someone makes money, someone else loses it.	The stock market is not a "zero sum" game. No one has to lose money for someone else to make money. While the founder of a successful corporation can become very wealthy, so, too, can many others, including investors who contribute the capital that helps get the business off the ground, employees who help make the business a success, and the government, which will be rewarded through the payment of additional taxes. When a public company makes money, lots of people benefit.
The stock market will always go up.	The markets go down as well as up, and individual stocks can and do decrease in value. Taken as a whole, however, the trend in the stock market continues upward. But in the short-term it can be volatile. That is why investors are advised to do their homework, buy stock in solid companies, and then hold onto it for the long term.
The markets are fixed.	A comprehensive system of state and federal regulation and industry self-regulation in the United States has resulted in the fairest and most efficient securities markets in the world. Although fraud still occurs, it is rare in relation to the volume of transactions that take place every day.
Investing is nothing more than gambling.	Investing isn't gambling or baseless speculation. It is taking reasonable risks to earn steady rewards. Unlike gambling, the odds are in the consumer's favor when money is invested wisely. Another key difference: A winning strategy in investing is based on knowledge, rather than random chance.

LESSON OUTLINE: HOW FINANCIAL MARKETS WORK

OBJECTIVE	**Students will:** • Identify markets they participate in. • Discuss the relationship between supply and demand.
MATERIALS	Internet access. • "Market Questionnaire" worksheet (Page 2.20).
PROCEDURES	**Teacher will:** • Discuss the markets in which high school students participate on a regular basis (clothing, technology, food, entertainment, etc.). Focus particularly on entertainment, as this will be the emphasis of much of the discussion. • Discuss recent local entertainment. Have the class list any concerts or sporting events that have taken place in your state in the past several months. What were the ticket prices for these events? Were the tickets sold out? If yes, were people selling their tickets for higher than the face value? If no, what happened to extra tickets people had—were they able to sell them, and, if so, how much did they receive? What causes people to pay more for a sold-out event than for one that is not sold out? How do consumer actions affect the price of such events? • Define and explain auctions (traditional and Internet). Discuss how they operate and how Internet auctions (such as eBay) and traditional auctions differ. What drives the price of an item up or down? How do individual actions affect the price of goods or services? **Students will:** • Participate in class discussion. • Visit an Internet auction site to view some of the transactions. **(Be cautious students do not bid on items.)**

LESSON OUTLINE: HOW FINANCIAL MARKETS WORK

ASSESSMENT	• Class participation. • "Market Questionnaire" worksheet (Page 2.20) may be used as a worksheet, a quiz, or an aid for students as they take notes.
ESTIMATED TIME	• 45-50 minutes class time, plus outside homework.
BEYOND THE CLASSROOM	• In a visit to the local mall, students can compare different stores to determine why some are more expensive than others. How does supply and demand affect the price of merchandise?

Name_____ Date_____

WORKSHEET: MARKET QUESTIONNAIRE

1. What is a market?

2. What markets do you participate in regularly?

3. Name a recent local sporting event, concert, or other entertainment event that you or someone you know has attended.

4. Were the tickets sold out? Yes____ No____

5. Were tickets sold for more than the original selling price, the same price as the original selling price, or less than the original selling price? Why were people willing to pay more or less for these tickets?

6. Why are some events more expensive than others? (For example, tickets for professional basketball games are more expensive than tickets to a Junior College basketball game.)

7. What is an auction?

8. How are prices set in an auction (Internet-based or traditional)?

9. How can consumers drive up an auction price?

10. What did you learn about auctions and bidding by visiting an Internet-based auction site?

LESSON OUTLINE: HOW FINANCIAL MARKETS WORK

OBJECTIVE	**Students will:** • Identify companies that do business in their community. • Determine which of these are public companies.
MATERIALS	• Notepad.
PROCEDURES	**Teacher will:** • Discuss the differences between a private and public company. • Assign students to keep a journal of all the companies they interact with for the next week. • Have students organize their lists to reflect which companies are public and which are private. • Use the "Company Questionnaire" worksheet to discuss how students will determine if a company is public or private (Page 2.22). **Students will:** • Keep a journal (for one week) of the food they eat, the clothes they wear, the cars they drive, the stores they shop in, the restaurants they frequent, the movies they see, the books they read, the music they listen to, the toiletries and cosmetics they use, and so on. At the end of the week, they will calculate how many different companies they interact with. • Determine which of the companies listed are publicly traded (using the method in the "Company Questionnaire").
ASSESSMENT	• Completed list of public and private companies.
ESTIMATED TIME	• 30 minutes in class plus outside homework.
BEYOND THE CLASSROOM	• Ask students to choose one of the companies included in their list to research in greater detail. The students should learn when the company opened for business; the company's ticker symbol; the company's stock performance in the past 10, 15, and 30 years; and the factors that would positively or negatively affect the stock price. Would the student consider investing in a company like this one—why or why not?

Name_____ Date_____

WORKSHEET: COMPANY QUESTIONNAIRE

One of the simplest ways to determine if a company is public or private is to contact them directly. Other ways to obtain this information include visiting the company's website or using Internet resources such as Yahoo! Finance at **http://finance.yahoo.com** or Hoover's Online at **http://www.hoovers.com**. Students may also visit the public library to gather company information from publications such as Moody's Investors Service and Value Line.

1. List the company's address, phone number, and website address.

Company Name:

Company Address:

Company Phone Number:

Company website:

2. Call the company to ask the following questions:

Are you a publicly traded company? ___ Yes ___ No

On which exchange is your company stock traded?

What is your company's stock symbol or stock abbreviation?

How can I learn more about this company?

(Will they send a company report, prospectus, or annual report?)

This questionnaire has been modified from the Motley Fool Investment Workbook, David and Tom Gardner, 1998, Simon and Schuster, NY, page 95.

Name_____ Date_____

READING STOCK TABLES

52-Week HI	52-Week LO	STOCK (DIV)	YLD %	PE	Vol 100s	Close	NET
91.54	75.10	NKE 1.24	1.5	16	16,893	83.30	0.75
45.26	39.36	KO 1.24f	3.0	20	45,034	41.26	0.11
36.75	27.36	MCD	1.9	17	106,322	34.85	-0.34

(Columns 1 and 2) Hi-Lo. During the past year (52 weeks) the highest price paid for a single share of McDonald's (MCD) stock was $36.75 and the lowest price per share was $27.36.

(Column 3) Company Name or Symbol and Dividend. The next column is the name (or abbreviation) of the firm issuing the stock, or the ticker symbol of the stock. If dividends are paid, the amount will be immediately next to the stock name. The example above shows that Nike (NKE) paid an annual dividend of $1.24 per share. The "f" after the Coca-Cola (KO) dividend indicates that this is the latest annual rate.

(Column 4) Yield. The yield column tells us that at today's price, investors in Coca-Cola Company (KO) receive a return of 3.0% or $3.00 for every $100 invested. The yield is derived by dividing the annual dividend by the closing price.

(Column 5) PE. This column is the **price to earnings (P/E) ratio**. The P/E ratio compares the price per share to the earnings per share. It shows how much an investor is willing to pay for $1 of current earnings per share (EPS). The P/E ratio is calculated by dividing the stock's price by the company's latest 12-month earnings per share (EPS).

(Column 6) Volume. The next column lists the volume of shares (in hundreds) that were traded on this date. In our example, on April 14, 2006, 16,893,000 shares of Nike were traded. Volume may give you an indication of the breadth of the market for a company's shares.

(Column 7) Close. The seventh WSJ column represents the last price at which a trade was made during the trading day. For example, Coca-Cola (KO) closed at $41.26 per share on this date.

(Column 8) Net Chg. The final column of the table stands for the change between the closing price for the previous day and the current day. The net change is measured in dollar value. In the example above, McDonald's shares closed at $.34 lower than it did the day before.

Note: The examples above represent NYSE-listed companies from the April 14, 2006 Wall Street Journal. Some newspapers may not follow the same sequence of column headings as the Wall Street Journal and some may provide less information (e.g. only providing the closing price and not the high and low for the day). Once students are familiar with the headings and the information they represent, they will be able to read the stock tables in any paper.

40.98 ▲ 0.13 41.78 ▼ 0.03 85.01 ▲ 5.59 34.85 ▼ 0.72 126.43 ▲ 1.24

LESSON OUTLINE: WHAT MAKES STOCK PRICES RISE AND FALL?

OBJECTIVE	**Students will:** • Identify how current events affect market conditions and stock prices.
MATERIALS	• If available, Wall Street Journal, Classroom Edition. Found on the Web at **http://www.wsjclassroomedition.com** (requires a subscription). • Internet access. • Graph paper. • "Evaluating Stock Prices" worksheet. (Page 2.26)
PROCEDURES	**Teacher will:** • Describe financial markets and how they operate. • Discuss the factors that affect the price of a stock. • List current events or news headlines that have appeared in the past two weeks. **Students will:** • Use the list of events discussed in class or find a newspaper article that discusses changes in a company or industry. • Choose a security that has been affected by these events. For example, if there are fluctuations in oil prices or unrest in oil producing countries, students could watch an oil company stock such as Exxon or British Petroleum. • Track and graph the closing price of that company stock.

LESSON OUTLINE: WHAT MAKES STOCK PRICES RISE AND FALL?

ASSESSMENT	• Completed graph of the stock and completed worksheet, "Evaluating Stock Prices" (Page 2.26).
ESTIMATED TIME	• 45-60 minutes in class plus outside homework.
BEYOND THE CLASSROOM	• Students will research the history of the Dow Jones Industrial Average. What does it tell us about the economic history of America? One free resource is the Dow Jones Web site.

Name_____ Date_____

WORKSHEET: EVALUATING STOCK PRICES

Use the graph of the stock that you followed to answer the following questions.

1. **What stock did you follow?**

2. **Explain the fluctuations in the stock during the time you monitored its price.**

3. **What were some of the possible causes of this fluctuation (if any)?**

LESSON OUTLINE: THE ROLE OF GOVERNMENT IN SECURITIES REGULATION

OBJECTIVE	**Students will:** • Research several regulatory organizations to learn about the role each plays in securities regulation.
MATERIALS	• Internet access. • "Securities Regulation Research Project" worksheet. (Page 2.28).
PROCEDURES	**Teacher will:** • Split the class into four or five groups. • Assign each group to research one regulatory organization. **Students will:** • Work in groups to research their assigned regulatory organization. • Use the "Securities Regulation Research Project" worksheet in their groups to gather information concerning their organization. • Plan and deliver, as a group, a class presentation outlining the assigned organization.
ASSESSMENT	• Involvement of each group member in a 5- to 10-minute oral presentation about the organization it has been assigned to research.
ESTIMATED TIME	• 60 minutes in class plus out-of-class research.
BEYOND THE CLASSROOM	• Students will search the Internet to find cases that a State securities agency or the SEC has brought against a broker, dealer, or securities firm.

Name_____ Date_____

WORKSHEET: SECURITIES REGULATION RESEARCH PROJECT

Instructions: Use the sites below to begin your research. Each presentation should answer the questions below.

U.S. Securities and Exchange Commission **www.sec.gov** National Association of Securities Dealers **www.nasd.com** National Futures Association **www.nfa.futures.org**	Visit the North American Securities Administrators Association website to locate your state securities agency information - **www.nasaa.org** New York Stock Exchange **www.nyse.com**

1. **When and how was this organization established?**

2. **What are the primary regulatory responsibilities of this organization?**

3. **What information does this organization require one to complete in order to file a complaint? How can a consumer obtain this information (Internet, phone, fax, mail)?**

4. **Where is the closest office located?**

Name_____ Date_____

UNIT 2 TEST

Matching

A. Diversification
B. Dividend
C. Liquid
D. Stock
E. Prospectus
F. The return
G. Securities
H. Tax-exempt
I. Bond
J. Appreciation
K. Mutual fund
L. No-load

1. _____Free of tax considerations

2. _____investment instruments such as stocks and bonds

3. _____where individuals "pool" investment money

4. _____ownership interest in a company

5. _____can easily be converted into cash

6. _____spreading investment money among different instruments and industries

7. _____legal document describing an investment offered for sale

8. _____amount gained or lost from an investment

9. _____an increase in the basic value of an investment

10. _____certificate representing a loan

11. _____a mutual fund which has no up-front or back-end fee

True or False

1. **T F** A savings account can be a building block for future investing.

2. **T F** Liquid investments can be easily converted into cash.

3. **T F** Risk tolerance refers to the amount of money you place in your no-risk savings account.

4. **T F** As a general rule, the greater the risk, the higher the potential rate of return.

5. **T F** Dividends are bonus payments made to company executives.

6. **T F** Municipal bonds are issued by publicly-held companies.

7. **T F** Load and no-load mutual funds have annual management fees.

UNIT 2—ANSWER KEY

Matching

1. H
2. G
3. K
4. D
5. C
6. A
7. E
8. F
9. J
10. I
11. L

True or False

1. True
2. True
3. False
4. True
5. False
6. False
7. True