
Introduction

Once you have your priorities in order, understand your personal and financial goals, and have written a thoughtful Investment Plan, you are ready to learn about securities markets, both physical and electronic, where financial or real assets are traded. What are the different types of securities markets in which you might invest? Who can help you achieve your goals? What are these individuals’ motivations, and how are they paid? How do you buy and sell securities, and what kind of help do you need? How do you choose someone to help you in the investment process? These and many other questions regarding securities markets will be addressed in this section.

Objectives

When you have completed this section, you should be able to do the following:

1. Recognize the different types of securities markets
2. Be aware of the basic characteristics of brokers and investment advisors
3. Understand how to buy and sell securities
4. Answer questions about choosing a broker or an investment advisor
5. Know use, types, and how to select and use investment benchmarks

Recognize the Different Types of Securities Markets

Securities markets are the markets in which securities, or financial assets, are traded. There are two different types of securities markets. The first is known as the primary market, which is used for trading newly issued securities. The second type is known as the secondary market, which is used for trading securities that have already been issued. Primary markets and secondary markets are generally used for trading equity securities.

Primary Markets

Primary markets, or primary financial markets, are where new financial assets are issued. There are two main types of primary-market issues. The first type of issue is known as an initial public offering (IPO). These issues are the very first shares a company offers to the public. Investment bankers serve as underwriters for these issues: they facilitate the process of selling them.

The second type of issue is known as a seasoned new issue. These issues are new shares that are issued by a company that already has publicly traded shares on existing stock exchanges. A seasoned new issue is the way a company sells more shares to the investing public.
Secondary Markets

Secondary markets, or secondary financial markets, trade existing securities (previously owned shares of stocks, bonds, and other financial assets). Secondary markets consist of both organized exchanges, such as the New York Stock Exchange (NYSE), and over-the-counter or electronic markets, such as National Association of Securities Dealer Automated Quotation System (NASDAQ).

Organized stock exchanges are markets that are used to facilitate the trading of financial instruments. The main organized stock exchanges are the New York Stock Exchange and the American Stock Exchange. There are also regional stock exchanges, such as the Pacific, Chicago, Philadelphia, Cincinnati, Intermountain, Spokane, and Boston Stock Exchanges, but these are very small.

The largest stock exchange in the United States is the NYSE. This stock exchange is more than 200 years old, and it is still limited to 1,366 seats (the number of individuals/institutions who can trade), which is the same number of seats it has had since 1953. NYSE includes over 3,000 listed companies. Generally, 80 percent of the daily trading volume in the United States is done on this stock exchange.

Over-the-counter (OTC) market is an electronic network of dealers that allows investors to execute trades without going through specialists or intermediaries. That is, there is no single physical location where stocks are traded; rather, these trades are executed through NASDAQ, which links various dealers and brokers through a computer- or telephone-based system. Usually the bigger companies are traded on an exchange rather than OTC. These trades are also executed through the National Market System, a system under the sponsorship of the National Association of Securities Dealers (NASD), which trades stocks of specific sizes, profitability, and trading requirements. NASD also trades “pink sheets,” or lists of small companies not listed on any exchange; these stocks are traded by brokers through a network of phone and computer systems and may be significantly more risky.

Secondary bond markets: An organized exchange for individual retail investors to trade bonds does not exist. This may be because there is little demand for bonds among individual investors; this may also be because the transaction costs to trade bonds are so small. Generally, individuals must work with a broker who buys or sells bonds through a bond dealer.

Government bond trading is dominated by investment houses, commercial banks, and the Federal Reserve. Some bonds, such as Series EE and I Bonds and some Treasury securities, can be purchased online at www.treasurydirect.gov.

International stock markets: There are domestic stock exchanges in developed countries and in many emerging or developing countries. Most nations have securities exchanges; these markets trade more than $25 trillion in assets. In the U.S. stock markets, investors can often trade American Depository Receipts (ADRs), which are receipts for shares that are held on deposit by
foreign banks and represent ownership of companies that have their primary listing on exchanges outside the U.S. Buying an ADR is very similar to buying the underlying domestic share from the issuer’s home or domestic market, except you get your dividends in U.S. dollars and your annual report information in English. Another way to invest in international shares is to invest in mutual funds; many mutual funds invest internationally.

**Be Aware of the Basic Characteristics of Brokers and Investment Advisors**

A stockbroker is a person who is employed by a commission house or merchant to solicit business for these institutions. An investment advisor is a person or organization that makes the necessary daily decisions regarding an investor’s portfolio. Both stockbrokers and investment advisors want to be responsible for making investment and trade decisions because they earn commissions and fees as they help investors buy and sell securities.

**How Stockbrokers and Investment Advisors Are Paid**

Stockbrokers and investment advisors are generally paid in three different ways:

**Commission:** Investors may be charged a commission on the trades they make. This commission requires investors to pay a percentage of every order. For example, the commission might be 80 basis points per trade (0.8 percent of each trade) or a specific charge per trade, such as $29.99 for a trade of 1,000 shares.

**Assets under management:** Investors may be charged a percentage of the value of assets that are under management. For example, if you have a $500,000 portfolio, and the advisor’s fee is 1 percent per year, you will pay the advisor $5,000 per year for helping you manage your portfolio.

**Combination pay:** Stockbrokers and financial advisors may charge fees that are a combination of both commissions and assets under management.

Regardless of who you work with, it is important that you know how the individual or institution is compensated. If individuals or institutions are unwilling to share this information with you, find someone who will. There are many excellent, qualified brokers and investment advisors who make compensation arrangements a part of every meeting with clients.

Generally, you must work with brokers or investment advisors if you are buying and selling stocks, bonds, and some mutual funds with loads, or sales charges. If you wish to purchase stocks, bonds, or load mutual funds, you will need to work with a broker.

If you only want to purchase no-load mutual funds and Treasury bonds, you can buy most of these directly from the mutual fund company without cost or from some brokers also without cost. You can buy some U.S. Savings bonds and Treasury securities directly from the U.S. Treasury at [www.treasurydirect.gov](http://www.treasurydirect.gov).
Types of Brokerage Firms

**Full-service brokers** offer a complete range of tools, research, and advice to help you trade assets and invest money. These are the most expensive type of brokers, but they offer the most services and research.

**Discount-service brokers** perform only the trading portion of investment management, but their services usually cost 50 to 75 percent less than full-service brokers.

**Deep-discount brokers** are even less expensive than discount-service brokers because they specialize in only one area. Like discount-service brokers, these brokers do trading only, but they often cost as much as 90 percent less than full-service brokers.

**Online-discount brokers** are similar to deep-discount brokers and offer support for online trading. These brokers are often less expensive than discount-service brokers, and they offer low-cost immediate trading and other services.

There are two additional categories of brokers: captive and independent. This delineation is generally made when investors are considering purchasing mutual funds.

**Captive brokers’** firms own part of a mutual fund company. Because of the ownership connection with this company, these brokers are often encouraged to sell the firm’s mutual funds rather than the mutual funds from other companies. Investors should be aware of this connection and make sure that a broker’s investment recommendations are in the investor’s best interest instead of the broker’s best interest.

**Independent brokers** are not part of a major chain and do not own a captive mutual fund company. These brokers may be more inclined to give unbiased advice because they do not sell specific mutual funds from a parent company.

Types of Brokerage Accounts

**Cash accounts** require you to leave money with the broker; this money is used to pay for purchases and to generate more money from the selling of securities. In trading, a specific amount of time is allowed between the notification of purchase and the deadline for payment. Therefore, having a cash account with a broker is a good idea in many cases because this account ensures that cash will be available for immediate payment upon the receipt of securities.

**Discretionary accounts** are accounts in which a broker or investment advisor is authorized to make trades for you. Exercise extreme caution in using this type of account; the broker can buy and sell securities at will, but you are responsible for paying all taxes and commission costs. Before you set up a discretionary account, make sure the broker has thoroughly read and understands your Investment Plan and your list of investment goals.

**Margin accounts** allow you to borrow money from the brokerage firm to purchase financial
assets. Since this type of account involves debt, it amplifies both gains and losses (see chapter 18: Investments 2: Creating a Personal Investment Plan on the website for more detail). Because the broker assumes a greater amount of risk with margin accounts, the broker requires you to maintain a specific maintenance margin in your account at all times; in other words, you must maintain a specific percentage of the value of the assets that have been purchased on margin. Currently, the maintenance margin is 50 percent. Should the value of the securities purchased on margin decline below this percentage, you will get a “margin call.” A margin call requires you to either put more money in your margin account or sell some of the assets you have purchased on margin to reduce the amount of money you owe. Rules for margin lending are federally regulated. I strongly suggest you do not buy on margin because you have the potential to lose more than the amount of your original investment. Buying on margin is a high-risk activity.

Understand How to Buy and Sell Securities

A broker is an intermediary between buyers and sellers of stock. An investor places orders with brokers, either indirectly by phone or fax, or directly through the Internet. The broker takes the orders to the securities exchange. If the broker is successful in finding a counter-party to the trade (i.e., a buyer is found when you want to sell a security, or a seller is found when you want to buy a security), the trade is executed on the exchange. The broker then notifies the investor that the trade has been made, and funds and securities are exchanged on the specified trade date (See Chart 1).

Types of Broker’s Orders

You can place orders to buy and sell securities with a broker in many different ways:

Buy-and-sell orders are directions you give to a broker to purchase or sell a specific number of shares at the market price or when the share reaches a specific price.

Market orders are directions to buy or sell a specific number of shares at the current market price. A benefit of this type of order is that it is the easiest to execute. A disadvantage is that the price may be significantly higher (for a buy) or lower (for a sell) than you had planned.

Limit orders are directions you give to a broker to buy or sell a specific number of shares at a specific price (or a better price, if possible). An advantage is that you may get the limit price or better. A disadvantage is that you may not get any shares at all if the market moves against you.

Day orders are buy-and-sell orders that are valid only until the end of the trading day. A benefit of this type of order is that at the end of the day you know everything you bought or sold. A disadvantage is that unfilled orders are automatically canceled.

Open orders, or good-till-canceled (GTC) orders are valid until they are filled or canceled. An advantage is that you can keep open orders for long periods of time, which may be helpful when dealing with securities that are thinly traded. A disadvantage is that if you fail to cancel these
orders, they could be unexpectedly filled at a later date. If this happens, you are responsible for paying any fees related to the order.

**Fill-or-kill orders** must either be filled or canceled immediately. Most often, these are market orders at the current market price. An advantage of this type of order is that you will know immediately whether you have purchased or sold the shares. A disadvantage is that your trade may not be executed.

**Chart 1. The Trading Process for Stocks and Bonds**

Stop **orders and stop-loss orders** directions to either sell a specific number of shares if the stock price falls below a certain level or to buy a specific number of shares if the stock price rises above a certain level. Use care when you set stop prices to safeguard against major fluctuations. An advantage of this type of order is that you can minimize loss if the market price of a security falls. A disadvantage is that the brokerage house may not be able to sell the asset at the stop-loss price if the market falls too quickly.

When you trade, use wisdom in your decisions. I generally recommend using limit orders, which are only good for one day; this way you are sure you will get the price you want (or nothing at all), and you are sure that at the end of every day, your orders will have all been canceled. I also recommend that you try to buy and sell shares in round lots. Round lots (orders of 100 shares or multiples of 100 shares) are easier to sell than odd lots (orders of 1 to 99 shares). You will get better execution and a better price if you sell and buy round lots.

**Share Registration**

Financial assets can be registered in a number of different forms, as is the case with most assets. Street name registration is where the shares of the stock remain in the broker’s custody and under the broker’s name. Joint accounts are where shares are jointly owned with a spouse or partner.
Joint tenancy is where shares are owned with a partner who has the right of survivorship. Tenancy in common is where shares are owned with a partner; however, when one shareholder dies, the shares of the deceased become the property of an heir, not the partner.

**Chart 2. The Trading Process for Mutual Funds with a Load, or Sales Charge (or Load)**

How do you choose an investment advisor or stockbroker? The key is to decide what kind of assistance you need and to get quality help from the best individuals and institutions. Whichever institution or individual you choose, remember that this individual or institution must be registered and licensed to sell the assets you are interested in buying or selling. While the terms “advisor” and “broker” are often used interchangeably, the difference is largely based on what type of assets each advisor has recommended historically.

You should base your decision about a broker or investment advisor on what you are buying or selling, how much help you want with the investment process, and how much you are willing to spend.

**What you are buying:** If you are buying stocks and bonds, you must use either a broker or an investment advisor who works with a broker. If you are comfortable making investment decisions yourself and you just need help executing your stock and bond trades, you might decide to use a discount-service broker or an online-discount broker. A discount-service broker will charge lower commissions on trading but will not provide investment advice. If you work with a discount-service broker, you will determine what to buy and sell, and you will give the orders to buy and sell. A discount-service broker executes your orders at a reduced price.

If you are not comfortable making your own investment decisions and would like someone to help you decide what to buy and sell, you may want to think about using a full-service broker or an investment advisor. A full-service brokerage firm provides a variety of services to its clients.
including research and advice, retirement planning, tax tips, and much more. The full-service broker helps you decide what to buy and sell, executes trades for you, and keeps you informed about changes in the market. These services come at a price, however; commissions for full-service brokers are much higher than commissions for discount-service brokers.

**Chart 3. The Trading Process for No-Load Mutual Funds**

If you invest only in mutual funds and make all of your asset allocation decisions yourself, you may not need a broker or investment advisor at all. You can buy many of your funds directly from the mutual fund family (the company that owns the mutual fund) or from a mutual fund supermarket that sells mutual funds from many different mutual fund families. Most of these purchases can be made directly without sales charges or loads (a fee charged to the purchaser for the privilege of purchasing the mutual fund and is generally used to compensate the broker for the work done to sell the mutual fund) or 12b-1 fees (fees charged to new investors to help cover the costs of selling the mutual fund to other investors). Be aware that the amount of your investment must meet a minimum investment requirement: many mutual fund families charge a fee if your account falls below the minimum required investment.

**Help in the investment process:** If you are comfortable making your own investment decisions, you may still appreciate some outside advice regarding your investments, or you may want to have someone to review your Investment Plans. If this is the case, consider talking with an investment advisor. A full-service broker or investment advisor can provide helpful advice about retirement planning, taxes, and other aspects of finance. You can negotiate for an up-front fee to pay for the specific amount of time you talk with the advisor or broker, or you can agree to make specific trades through the advisor to compensate for the advice.

**How much you are willing to pay?** If you are concerned about costs, you can purchase mutual funds directly from a mutual fund family, generally without fees. If you are buying or selling stocks or bonds, you can work with a discount-service broker or an online-discount broker so that you will pay the lowest costs possible.
Working with a Broker or Advisor

When working with a broker or advisor, remember that you are working with your money. Do your homework and take responsibility for your money. No one will watch it like you will.

Brokers and investment advisors offer specialized knowledge to help you in the investment process. However, if you do not need their services, you should not pay for them. Save money by using a discount-service broker or consider using no-load mutual funds if you feel comfortable making investment decisions yourself. Using alternatives to full-service brokers can greatly reduce your costs, especially because these alternatives may not charge transaction costs.

Keep transaction costs and taxes to a minimum. A percentage saved in cost is a percentage earned in return. Try to keep your trading to a minimum to reduce transaction costs and taxes. Likewise, if you buy mutual funds that have low turnover, you can reduce the amount of taxes you will have to pay each year due to mutual fund distributions. You may also be able to reduce costs by using index funds and applying a buy-and-hold strategy. Regarding bonds, you can work with a broker or buy direct. If you go through a broker or advisor, you will generally have to pay transaction costs.

Trusted Advisor versus Salesperson

Look for brokers or investment advisors that have your best interest in mind. Make sure trading is to achieve your goals—not theirs. Make sure they have the necessary expertise and licenses in the financial areas you think are important. If they don’t have the licenses, they cannot sell you the securities. Make sure they don’t trade a lot, or “churn” your portfolio. It’s not what you make but what you keep after all costs, taxes, and inflation that makes you wealthy.

Look for brokers with integrity, intelligence, and efficiency. Make sure they are upfront regarding all costs and commissions. If they will not tell you their commission, go somewhere else. Look for brokers with experience in both up and down markets. Generally, you will not find this type of experience in someone who cold-calls you on the phone. Make sure your broker listens. Ensure he or she will spend the time with you to know your investment philosophy and read your Investment Plan. If not, go somewhere else. Finally, choose a broker that has a reputation for allowing customers to say “no” without pressure. If you ever feel pressure to make a trade, get another broker.

There is a difference between a trusted financial advisor (TFA) and a salesperson. A trusted financial advisor has your best interest at heart, while a salesperson has his or her best interest at heart. The following are a few differences you should be aware of:

- A TFA follows a process to help you create a comprehensive financial plan. A salesperson has a technique for making a sale and placing a trade.
- A TFA is interested in the things that are important to you. A salesperson is interested in making small talk, making you feel comfortable, and then making the sale.
• A TFA requires you to bring all financial data to the first meeting but does not require you to disclose information you are not comfortable sharing. A salesperson does not require you to do anything but show up and asks probing, personal questions that are designed to make you feel uncomfortable so you will buy the products he or she recommends.

• A TFA expresses interest in you and frequently refers to the work you have done so far in your financial plan; a TFA makes an effort to understand you and your goals. A salesperson refers to the possibility of your impending demise, the need to protect your family, and so on in an attempt to scare you into buying a product.

• A TFA meets in a professional environment with all of the financial decision-makers. A salesperson will meet with anyone, anytime, anywhere for “convenience.”

• A TFA will not allow you to talk him or her into selling you a product that is not appropriate for you, even if you insist. A salesperson will sell you anything you want to buy or will redirect you to a preferred product that gives him or her a higher commission.

• A TFA works with you even during times when you are not doing much trading. A salesperson only works with you if you are generating commissions.

As you review your experience with brokers or financial advisors, you can come to understand the type of advisor you were working with. The key is to work with a trusted financial advisor, whether that person is registered as a financial advisor or a broker.¹

Choosing a Broker or Advisor

The best brokers and investment advisors are those that have your best interests in mind. They have expertise in the financial areas that are important to you, they make you feel comfortable, they have read and understand your Investment Plan, and they do not trade a lot. They are looking out for number one—you.

There are a number of important areas you should consider if you are thinking about hiring a broker or advisor. Some of these areas are listed below and include some of the basic questions you should ask before hiring anyone to help you manage your finances.

1. Are you a full-time broker/registered investment advisor (RIA)/financial planner (FP)?

   Work with brokers/RIAs/FPs who work full time at their business. This gives you greater assurance that they are knowledgeable about the products you need.

2. What is your education and what licenses do you have?

   Many financial advisors have had little or no financial training. There are no required courses for someone who wants to be called a financial advisor. If you are paying for help, get the best help you can. I recommend you stick with advisors that have trained and qualified for specific designations, such as certified financial planners (CFPs), chartered financial analysts (CFAs), and certified public accountants (CPAs).
Make sure you choose licensed financial planners. If you require stock and bond assistance, they should have their CFA or Series 7. If they are RIA, they should have their Series 65 and 66. If they are financial planners, I recommend they be CFPs.

3. How long have you been a full-time broker/RIA/financial planner?

Work with someone who is experienced and established.

4. Are you working as a fiduciary or an advisor?

Fiduciaries are required to recommend products that are in the best interests of their clients. Some fee-based advisors at brokerage firms are held to a lower standard that only requires that they recommend products that are a reasonable choice for their clients. I recommend that you work only with advisors that will commit to acting as fiduciaries on your behalf, and that will act only in your best interests.

5. Do you offer only investment advice or full financial-planning services?

Many advisors only offer investment advice. But taking into account what you have learned from this course, you must realize that there is much more to comprehensive financial planning than choosing financial assets. I recommend you work with someone who will help you in those other areas as well, including goals, budgets, mortgages, insurance, taxes, retirement planning, and so on.

6. What companies do you represent?

There is a trade-off here between captive and independent brokers/RIAs/FPs. If they work with multiple companies, they may be able to offer more competitive products. If they only work for one company, they may be limited (or biased) in what they recommend.

7. How are you compensated?

Many advisors earn money by collecting commissions on the investments they sell. While they are compensated for the time they spend, there is no additional incentive for them to watch your investments after you have purchased them because they make no additional fees. In addition, there is the potential for conflict of interest, as well as for excessive trading. Remember that every dollar in commissions you pay reduces your returns, and every time you sell a security, you create a taxable event that may require you to pay more taxes. You want to make sure the broker/RIA/FP is working on your behalf. By knowing the commission on various policies, you may be able to avoid investments that are more of a benefit to the broker than to you.

8. Tell me about your proposed assistance:
A. Trading commissions: How much will it cost to buy stocks or other securities? Are there different prices for market and limit orders? What are those prices? Does your firm offer both safekeeping and recordkeeping services?
B. Other fees: What are your annual maintenance or custody fees? Are there inactivity fees if you’re not a frequent trader?
C. Minimum initial deposit: What is your minimum initial deposit? What is the monthly fee for going below this minimum?
D. Customer service: How good is your customer service? Do you have references? Do you have an 800 number for transactions and quotes?
E. Traditional banking services: Do you offer traditional banking services? Can I write checks on my account?
F. Research: Do you provide objective, independent security analysis? Do I have to pay for reports?
G. Mutual funds: Do you have access to high-quality, low-cost fund families outside the funds sold by the broker, such as Vanguard/Fidelity? If not, what is the cost for me to invest with these fund families?
H. Investment product selection: Do you have certificates of deposit, bonds, options, and so on? (List the items you may want to invest in.)
I. Insurance: Is my account insured by the Securities Investor Protection Corporation (SIPC) to $500,000?
J. Other methods of trading: How do you make trades if your computer is down or you’re away from home? Can you trade via phone?
K. Other perks: Do you have any special deals that would make it more attractive for me to work with you? Do I receive interest on idle cash in your account?

9. Do you have any clients who are willing to recommend you?

Your broker should either supply you with names of satisfied clients or share testimonial letters from others. You should not consider a broker/RIA/FP without recommendations.

While it may be time consuming to find a good financial planner/broker/registered investment advisor, the correct choice can be very beneficial in helping you achieve your personal and financial goals.

Know Uses, Types, and How to Select and Use Investment Benchmarks

Now that you know about securities markets and the investment personnel that can help, it is important that you understand Principle 7: Compare Performance versus Benchmarks. This section will discuss benchmark basics, types, construction, weighting, and finding data.

Benchmark Basics

A benchmark (also called an index) is a measuring device that shows the average performance of a specific set of securities; benchmarks are used for comparison purposes. Benchmarks may be
modeled after published indexes or customized to fit a specific investment strategy. Benchmarks are the standard by which you should judge the performance of individual assets in your portfolio; they also allow you to evaluate your portfolio as a whole. You cannot know how well your portfolio is performing unless you have a benchmark against which to compare that portfolio. Comparing asset performance to benchmarks is Principle 7 of successful investing.

There are three primary purposes of benchmarks. First, benchmarks allow you to track the average returns of a specific asset class. Second, benchmarks allow you to compare different mutual fund managers in similar asset classes; similarly, benchmarks allow you to monitor recommendations made by financial brokers. Third, benchmarks give you a framework for building new portfolios and exchange traded funds (ETFs).

The following are a few questions you should ask yourself when choosing a benchmark:

- Does the benchmark represent the assets I am interested in?
- How broad is the benchmark?
- How many securities does the benchmark include?
- How is the benchmark constructed?
- How is the benchmark weighted?

**Benchmark Types**

**Type:** Benchmarks may be categorized by type of financial asset—stocks, bonds, and other asset classes. Stock benchmarks are subdivided by market capitalization, geography, industry, and investment style. Bond benchmarks are subdivided into corporate bonds, government bonds, convertible bonds, agency bonds, municipal bonds, junk bonds, and so on. Each asset class defines its own benchmarks: for example, real estate investment trusts (REITs), currencies, commodities, derivatives, gold, and hedge funds each have their own benchmarks.

**Geography:** Global benchmarks measure the performance of assets in several developed market countries, including the United States. Examples of global benchmarks include MSCI World and MSCI All Country Free. International benchmarks measure the performance of assets in developed countries outside the United States. An example of an international benchmark is the MSCI Europe, Australia, and Far East index (EAFE). Emerging markets benchmarks measure the performance of less-developed markets in Asia, Latin America, emerging Europe, and Africa. Examples of emerging markets benchmarks include the S&P/IFC Emerging Markets Free index and the MSCI Emerging Markets Free index. Regional benchmarks measure the performance of assets in a specific region of the world. Examples of regional benchmarks include MSCI Europe, MSCI Asia, Dow Jones Asia, and Dow Jones Latin America. Country benchmarks measure the performance of assets in a specific country. Examples of country benchmarks include the S&P 500, Russell 5000, Dow Jones, MSCI Argentina, S&P/IFC Chile, and Japan TOPIX.

**Asset size:** Market capitalization is the most common division within this category. Market
capitalization benchmarks measure the performance of assets with a specific market capitalization range. Large-cap stocks generally have a market capitalization of greater than $10 billion, mid-caps are between $2 billion and $10 billion, and small-caps are less than $2 billion. Micro-cap stocks, a less common benchmark, generally have a market capitalization of less than $250 million.

**Industry:** Industry benchmarks (also called sector benchmarks) measure the performance of assets in a specific industry, such as telecommunications or retail. Industry benchmarks may also be subcategorized by geography; for example, there are industry benchmarks specifically for the Japanese automotive industry, the European telecommunications industry, and the Asian cement industry.

**Investment style:** Investment-style benchmarks measure the performance of stocks with different values. Value benchmarks measure the performance of stocks that are considered to be undervalued by the market; in other words, their price-earnings and price-book ratios are lower than the average price-earnings and price-book ratios for all companies. Growth benchmarks measure the performance of stocks that are expected to have accelerated growth caused by increased earnings, a dominant market position, or other factors; in other words, the price-earnings and price-book ratios for these stocks are higher than the average price-earnings and price-book ratios for all companies. Blend benchmarks measure the performance of all stocks in that asset class, both value and growth stocks.

**Maturity:** Long-term benchmarks measure the performance of bonds that will mature in more than 10 years. Intermediate-term benchmarks measure the performance of bonds that will mature in 2 to 10 years. Short-term benchmarks measure the performance of bonds that will mature in less than two years.

**Benchmark Construction**

There are a number of different ways that benchmark returns are calculated. The price return method calculates only the price appreciation of the underlying assets. The total return with gross dividends reinvested method uses both the price return and the dividend return to calculate the total return. However, the gross dividends method does not account for the impact of withholding taxes on dividends, which may be required for international investing.

The total return with net dividends reinvested method uses both price and dividends to calculate the total return. The total return with net dividends reinvested method accounts for the impact of international withholding taxes on dividends. Thus, benchmarks that use this last method of calculating returns will report a smaller return compared to the amount of return reported by methods that base calculations on the gross dividends; however, the total return with net dividends reinvested method will better represent the amount of return an international investor will actually receive.

**Benchmark Weighting**
Assets are weighted in a variety of ways, depending on the benchmark:

**Market-value weighting:** If assets are market-value weighted, they are weighted according to their market capitalization. An asset’s market capitalization is found by multiplying share price by outstanding shares. This method assumes that market capitalization is a viable representation of asset size. Market-value weighting is the primary way most benchmarks weight assets. Indexes that are market-value weighted include the S&P 500; NASDAQ; and most MSCI global, country, and regional benchmarks. These benchmarks give a higher weighting to stocks with a greater market capitalization.

**Price weighting:** Benchmarks that use price weighting assume that the weight of a stock should be related to the price of the stock. In other words, a stock that trades at $10 is considered twice as important as a stock that trades at $5. Price-weighted benchmarks base the weight of an asset on the price of the stock. Examples of price-weighted benchmarks include the Dow Jones Industrial Average and Japan’s Nikkei index.

**Equal weighting:** Equally weighted benchmarks consider all stocks to have the same weight. These benchmarks place the same value on a stock with a market capitalization of $50 billion as they do on a stock with a market capitalization of $250 million. Examples of equally weighted benchmarks include the Value Line index and the MSCI Equal Weighted index.

**Float weighting:** Benchmarks that use float weighting assume that asset weightings should be based on both market capitalization and the amount of float outstanding. The amount of float outstanding refers to the number of shares that are actually available to investors (usually international investors); the amount of float outstanding does not include shares that are held by insiders or shares that are available only to local country investors. Examples of benchmarks that use this weighting system include the S&P/IFC Emerging Markets Free index and the MSCI Emerging Markets Free index. These benchmarks give a higher weight to companies that have more shares in the marketplace and companies that do not limit foreign ownership.

**Finding Data on Benchmarks**

You can find data on benchmarks in a number of places. Data on several benchmarks are accessible through the Internet on financial sites such as CNN Money or Yahoo! Finance. These free benchmarks do not typically account for dividends, so make sure you take this into account when looking at index performance.

Proprietary data providers, such as Morgan Stanley and Standard & Poor’s, have their own benchmarks. They will also design custom benchmarks for a fee; the MSCI Emerging Markets Free ex-Malaysia index is one example of a custom benchmark. Other data suppliers include NASDAQ, Bloomberg, and Reuters.

**Key Characteristics of Benchmarks**
The purpose of a benchmark is to reflect the performance of specific asset classes or funds. Any benchmark you choose should have the following five characteristics:

1. The benchmark should be constructed according to objective rules, not subjective judgments. There should be specific reasons for why each asset is included in the benchmark.

2. The benchmark should consistently weight its holdings according to its chosen weighting method. Choose benchmarks that use a weighting method you agree with.

### Table 1. Key Benchmarks for the Major Asset Classes

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Benchmarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Equities</td>
<td></td>
</tr>
<tr>
<td>Large-Cap Stocks</td>
<td>S&amp;P 500</td>
</tr>
<tr>
<td>Small-Cap Stocks</td>
<td>Russell 5000</td>
</tr>
<tr>
<td>Micro-Cap Stocks</td>
<td>Wilshire Micro-Cap</td>
</tr>
<tr>
<td>International Equities</td>
<td></td>
</tr>
<tr>
<td>Global</td>
<td>S&amp;P Global 1200, MSCI &amp; DJ World</td>
</tr>
<tr>
<td>International</td>
<td>EAFE (Europe, Australia, and the Far East)</td>
</tr>
<tr>
<td>Corporate Bonds</td>
<td></td>
</tr>
<tr>
<td>Short-Term</td>
<td>DJ Corporate Bond</td>
</tr>
<tr>
<td>Intermediate-Term</td>
<td>Barclays Intermediate</td>
</tr>
<tr>
<td>High-Yield</td>
<td>Salomon Smith Barney High Yield</td>
</tr>
<tr>
<td>Mortgage-Backed</td>
<td>Barclays MBS</td>
</tr>
<tr>
<td>Yankee</td>
<td>Merrill Lynch Yankee</td>
</tr>
<tr>
<td>Treasury Securities</td>
<td></td>
</tr>
<tr>
<td>Intermediate-Term</td>
<td>Barclays Intermediate</td>
</tr>
<tr>
<td>Long-Term</td>
<td>Barclays Long-Term Treasury</td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
</tr>
<tr>
<td>Real Estate Investment Trusts</td>
<td>S&amp;P REIT</td>
</tr>
</tbody>
</table>

3. The benchmark should feature overlapping buffer zones at the cutoff points between large-, mid-, and small-capitalization holdings. It is a bad sign if many holdings in the benchmark are considered small-cap stocks one day and mid-cap stocks the next day due to changes in the market.

4. The benchmark should use a variety of factors to determine whether a stock is a growth
stock or a value stock. The benchmark should have buffer zones to prevent assets from changing their status daily.

5. The benchmark should gradually and carefully rebalance its holdings to reflect market changes. This rebalancing should take place infrequently—once a year at most.

**Key Benchmarks**

Some key benchmarks are found in Table 1.

**Summary**

There are two different types of securities markets. The first type is known as the primary market and is used for trading newly issued securities. The second is known as the secondary market and is used for trading securities that have already been issued. Primary markets and secondary markets are generally used for trading equity securities.

A stockbroker is a person who is employed by a commission house or merchant; stockbrokers solicit business for these institutions. An investment advisor is a person or organization that makes the necessary daily decisions regarding an investor’s portfolio. Both stockbrokers and investment advisors want to be responsible for making investment and trade decisions because they earn commissions and fees as they help investors buy and sell securities. Stockbrokers and investment advisors are generally paid in three different ways: commissions, assets under management, or a combination of commission and assets under management.

There are a number of different types of brokerage firms. There are three main types of accounts: cash accounts, discretionary accounts, and margin accounts.

A broker is an intermediary between buyers and sellers of stock. An investor places orders with a broker, either indirectly by phone or fax or directly through the Internet. The broker takes the orders to the securities exchange. If the broker is successful, the trade is executed on the exchange. The broker then notifies the investor that the trade has been made, and funds and securities are exchanged on the specified trade date (See Chart 1).

Orders to buy and sell securities can be placed with a broker in many different ways. Buy-and-sell orders are directions that tell a broker when to purchase or sell a specific quantity of a security at either a pre-determined price or the market price. There are a number of different types of orders, and each type has specific advantages and disadvantages. Types of orders include market orders, limit orders, day orders, good-till-canceled (GTC) orders, fill-or-kill orders, and stop or stop-loss orders.

It is important to work with good people and institutions. Working with brokers and financial advisors can be challenging. You must understand what you want to accomplish, what you expect from the broker or advisor, and how the broker or advisor will be paid. You should be paying brokers and advisors to add value to your portfolio—you should not be paying them to do
what you could do for yourself.

Finally, if you decide you need help, it is important to work with qualified, licensed, and appropriate institutions and individuals. Work with a trusted financial advisor, not just a salesperson.

A benchmark (also called an index) is a measuring device that shows the average performance of a specific set of securities: benchmarks are used for comparison purposes. Benchmarks may be modeled after published indexes or customized to fit a specific investment strategy. Benchmarks are the standard by which you should judge the performance of individual assets in your portfolio; they also allow you to evaluate your portfolio as a whole. You cannot know how well your portfolio is performing unless you have a benchmark against which to compare that portfolio. Comparing asset performance to benchmarks is a principle of successful investing.

Assignments

Financial Plan Assignment

Continue to work on your Investment Plan. As you do, it is important that you understand the environment in which you are investing. Understanding the key components of this environment is critical. You should decide whether you can invest on your own or whether you will need help. When assets are small, you can often make important decisions on your own. As the size of your assets increases, it may be a good idea to get help with your investment decisions.

First, be familiar with the major players in the investment world. Come to understand the strengths and weaknesses of each of the different providers of financial advice. Make sure they are operating in your best interests as fiduciaries, not just as brokers.

Second, think through the importance of diversification as you put your Investment Plan together. Fear and greed are typical feelings that affect us all. In order to minimize the problems of fear and greed, determine investment policies to help you as you work to achieve your goals.

What is the maximum amount you will invest in any single investment? We are not talking about mutual funds, index funds, or ETFs, but single investments. Most institutions have a maximum of between 5 and 10 percent. Include your maximum total in Section III.A.2.

Third, determine whether you will use leverage to invest. Leverage is debt. I encourage you to not short-sell securities or buy on margin, but you can include your guidelines in Section III.A.3. Also, do not invest with borrowed money.

Finally, determine your investment benchmarks. Investment Principle 7 advises you to monitor portfolio performance. This means you must choose an appropriate benchmark for each of your asset classes and for each of your assets. If you would like help, I have included recommended benchmarks for each of the asset classes in Expected Return Simulation and Benchmarks (LT27). When you select the asset classes in the spreadsheet you will receive three
recommendations for asset class benchmarks. Include these benchmarks in Section III.B.1. and III.B.2. You will not include the allocations yet, but you should add the benchmarks.

Review Materials

Terminology Review

**Assets under management.** This is another way an investment advisor is paid. It is calculated as a percentage of your assets under management, i.e., if you have $500,000 with an advisor and their fee is 1.0% per year, you will pay them $5,000 per year.

**Captive brokers.** These are brokers whose company is part of a group which owns a mutual fund company. These brokers may be encouraged to sell company mutual funds which may not be the best fit for the investor but are in the interest of the company.

**Cash accounts.** This is money with the broker which you use to pay for purchases or receive any cash. There is a specific time between notification of purchases and when the purchases must be paid.

**Commissions.** Commissions are the way a broker or investment advisor is paid. It is either a percentage of every buy or sell order (e.g., 20 bps per trade), or a specific charge for a trade (e.g., $9.99).

**Day orders.** These are orders to buy and sell securities which are good only until the end of the trading day.

**Deep-discount and On-line brokers.** These are brokers who are even cheaper than discount brokers. They do only trading, but at a 90% discount to full-service brokers. Online can even be cheaper with other services.

**Discount-service brokers.** These are brokers who only perform trading, but usually at a 50% to 70% discount to full-service costs.

**Discretionary accounts.** These are accounts where you authorize a broker or investment advisor to make trades for you and your account. Exercise caution with this as the broker can buy and sell securities at will and you are responsible for all taxes and commission costs.

**Fill or kill orders.** These are orders which must be either filled or canceled immediately. Most often these are market orders.

**Full-service brokers.** These are brokers who will give you all the tools, research and other advice to help you trade and invest.
**Independent brokers.** These are brokers whose company is not part of a major chain or who own a captive mutual fund company. They may be inclined to give unbiased advice as they do not sell specific mutual funds.

**Initial public offerings (IPOs).** These are the very first shares ever issued by a company. Investment bankers serve as underwriters or intermediaries for these IPOs.

**Investment advisor.** A person or an organization that helps makes the day-to-day decisions regarding a portfolio’s investments for investors.

**Limit orders.** These are orders to sell or buy a specific number of shares at a specific price or better. This is generally the best method in working with brokers.

**Maintenance margin.** This is money you put up to buy on margin. If your maintenance margin falls below a specific level, you will be required to put up more money. If not, your position will be closed out.

**Margin accounts.** These are accounts where you borrow from the brokerage firm to purchase financial assets. This is debt, and can amplify both gains and losses.

**Margin call.** This is a call by the broker to put up more money when your margin declines below a certain level. I recommend you do not buy on margin. It is using debt to invest and you can lose more than your original investment doing this.

**Market orders.** These are orders to sell or buy a specific number of shares at the currently available or market price. Be careful as the market can move quickly and dramatically between when you place the order and order execution time.

**Open orders** (GTC: good till canceled, GTD: good till date specified). These are orders which are good until filled or canceled. Be very careful with open or GTC/GTD orders. If you fail to cancel specific orders, you might have orders filled that you forgot to close out.

**Organized Exchanges.** These are areas used to facilitate trading of financial instruments.

**Over-the-Counter (OTC) Market.** This is an electronic network of dealers used to execute trades without specialists or middle-men.

**Primary markets.** These are markets for trading newly issued securities.

**Seasoned new issues.** These are new shares being issued by a company that is already publicly traded.

**Secondary markets.** These are markets for trading already issued securities. Secondary markets trade previously owned shares of stocks, bonds, and other securities. Secondary
markets consist of organized exchanges and over-the-counter or electronic markets where existing shares are traded.

**Securities markets.** Securities markets are where securities, i.e., financial assets, are traded. The two different types of securities markets are primary and secondary markets.

**Stockbroker.** A stockbroker is a person who is employed by and solicits business for a commission house or merchant.

**Stop (or stop-loss) orders.** These are orders to sell a specific number of shares if the stock price falls below a certain price or buy a specific number of shares if the stock price rises above a certain price. These are used to set prices to safeguard against major fluctuations.

**Review Questions**

1. What are securities markets?
2. What are the two types of securities markets? What role does each play in the securities market?
3. What are organized stock exchanges? What are the two main organized stock exchanges?
4. What is a stockbroker? Investment advisor? In what three ways are they usually paid?
5. What are the five questions you should ask before hiring a financial advisor?

**Case Studies**

**Case Study 1**

**Data**

After studying the fundamental trends in CHKP Company’s annual report and doing a lot of research, Steve decided to purchase one round lot of the firm’s stock on the open market. On Monday morning he calls a stockbroker and asks for the price of CHKP stock. The broker indicates that CHKP is bidding at $45.12, with an asking price of $45.19.

**Calculations**

A. Assuming Steve wants to place a market order to purchase shares, how much will he most likely pay (assume there are no major moves in the stock price)?

B. What are the advantages and disadvantages of a limit order versus a market order?

**Case Study 1 Answers**

A. The asking price of CHKP, $45.19, is the amount Steve would most likely have to pay for each share of CHKP stock. So, assuming he purchased a round lot (100 shares), Steve would pay $45.19 \times 100 = $4,519 (assuming there were no commissions).

B. The advantage of a limit order is that it is not executed unless the stock reaches the specified price or better. The disadvantage is that it may not be executed if the market rises.
Case Study 2

Data
Steve’s purchase of 100 shares of CHKP has been a good investment. Yesterday the stock closed at $53.75 per share. In order to lock in his gains, Steve decides to employ a stop-loss order.

Application
A. Assuming Steve sets the stop-loss order at $53, what is likely to happen?
B. At what price would you recommend setting the stop-loss order? Why?

Case Study 2 Answers
A. Because the stop-loss order price of $53 is set so closely to the recent close of $53.75, it is likely the stock will be sold when it fluctuates around its closing price. When stop-loss orders are set too close to the market price, the chance of the price declining results in too much trading. This generates high commission costs and taxes for the seller. Steve should hold for the long term and put his stop-loss orders farther away from the current price.
B. Steve should set his stop-loss order to safeguard against a major fluctuation, not a minor fluctuation. A stop-loss price of $49 or $50 would be more appropriate; this price is 7 to 10 percent below the current market price.

1 (Main ideas for this section were from Jason Payne, Payne Financial Management, Orem, UT; and Bill Bachrach; Values Based Financial Planning; Aim High Publishing; San Diego, CA, 2000).