Chapter 11: Financial Markets
Section 3

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ECONOMICS

PEARSON

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Objectives

1. **Identify** the benefits and risks of buying stocks.
2. **Describe** how stocks are traded.
3. **Explain** how stock performance is measured.
4. **Describe** the Great Crash of 1929 and more recent stock market events.

Key Terms

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- **share:** a portion of stock
- **capital gain**: the difference between the selling price and purchase price that results in a financial gain for the seller
- **capital loss**: the difference between the selling price and purchase price that results in a financial loss for the seller
- **stock split**: the division of each single share of a company's stock into more than one share
- **stockbroker**: a person who links buyers and sellers of stock

Key Terms, cont.

- **brokerage firm**: a business that specializes in trading stocks
- **stock exchange**: a market for buying and selling stock
- **futures:** contracts to buy or sell commodities at a particular date in the future at a price specified today
- **options:** contracts that give investors the right to buy or sell stock and other financial assets at a particular price until a specified future date
- **call option:** a contract for buying stock at a particular price until a specified future date

Key Terms, cont.

- **put option**: a contract for selling stock at a particular price until a specified future date
- **bull market**: a steady rise in the stock market over a period of time
- **bear market**: a steady drop or stagnation in the stock market over a period of time
- **speculation**: the practice of making high-risk investments with borrowed money in hopes of getting a big return

Introduction

- How does the stock market work?
  - Stock, or shares in a company, are bought and sold on the stock market.
  - Stock brokers help individuals and businesses invest their money in the stock market.
  - Investors can keep track of the stock market by checking their local paper. When the market is doing well, people see a large return on the initial investment. When it is not doing well, people may lose a great deal of money.

Benefits of Buying Stock

- Checkpoint: What are two ways that an investor can make a profit from buying stocks?
- In addition to selling bonds, corporations can raise money by selling stock shares in that corporation.
- The benefits of buying stock include:
  - Dividends—part of the firm’s profits
  - Capital gains—selling the stock for more than you paid for it

Types of Stock

- Stock may be classified by whether or not it pays dividends.
  - Income stock—provides investors with income by paying dividends
  - Growth stock—pays few or no dividends and earnings are reinvested in the company

Types of Stock, cont.

- Stock is also classified by whether or not the holder has a voice in the company:
  - Common stock: These holders are voting members of the company.
  - Preferred stock: These holders are nonvoting members of the company.

- Common stock owners may initiate a stock split when the price of a stock becomes to high.

Risks of Buying Stock

- Buying stock is risky because the dividends are determined by how well a company is doing.

- Because of the laws governing bankruptcy, stocks are riskier than bonds since bondholders are paid before stockholders when a company goes bankrupt.

How Stocks are Traded

- If you want to buy stock, you would first contact a stockbroker to advise you on which stocks to buy.
- You buy stocks on a secondary market known as a stock exchange.
  - The New York Stock Exchange is the country's largest and most powerful exchange, handling stock and bond transactions for the top companies in the United States and the world.
  - The Nasdaq is the second largest securities market and the largest electronic market.

Futures and Options

- Futures are contracts to buy or sell commodities at a particular date in the future at a specified price today.
- Similarly, options are contracts that give investors the choice to buy or sell stock and other financial assets.
- Most people who buy stock hold their investment for a significant period of time.
  – Day traders, on the other hand, trade stocks daily, which is very risky.

Measuring Stock Performance

- When the stock market rises steadily over a period of time it is known as a bull market.
- When the stock market falls or stagnates for a significant period it is a bear market.
- The Dow Jones Industrial Average measures stock performance. It represents the average value of a particular set of stocks, and it is reported as a certain number of points.

The Great Crash

- Checkpoint: What was the Great Crash of 1929?
- In the 1920s, the stock market was soaring.
  - Speculation and buying on margin, however, led to a crash in the market that crippled the U.S. economy.
- The Dow began steadily dropping in September, 1929. People began to sell their shares and companies couldn't keep up with it. On October 29, 1929, a record 16.4 million shares were sold and the market crashed.

The Aftermath

- The Crash led to the Great Depression.
  - Many people lost everything—their homes, their jobs, and their farms.
- After the Depression, many people saw stocks as risky investments and avoided them.
- By the 1980s, with the development of mutual funds, Americans became more comfortable with stock ownership once again.
  - The stock market crashed again in 1987 but was able to recover much faster than in did in 1929.

Scandals & the Stock Market Today

- By the 1990s, when people began once again to buy more stock, investors started to worry that many companies could not make enough money to justify their high stock prices.
- The Enron scandal and others caused many investors to question how much they knew about the companies they invested in.
- In 2008, the stock market began falling, causing a major economic crisis in the United States once again.

Review

- Now that you have learned how the stock market works, go back and answer the Chapter Essential Question.
  - How do your saving and investment choices affect your future?