Trinity Wealth Management, LLC
Robert Wassel, CPA/PFS
Chief Investment Officer
8041 Hosbrook Road
Suite 422
Cincinnati, OH 45236
513-794-2870 x11
(513) 289-2352 cell
bob@gotrinitywealth.com
www.gotrinitywealth.com

Investing in Stocks

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Businesses sell shares of stock to investors as a way to raise money to finance expansion, pay off debt, and provide operating capital. Each share of stock represents a proportional share of ownership in the company. As a stockholder, you share in a portion of any profits and growth of the company. Dividends from earnings are paid to shareholders, and growth is realized by the increase in value of the stock.

Stock ownership also generally gives you the right to vote on management issues. Company executives work for the shareholders, who are represented by an elected board of directors. The goal of management is to increase the value of the corporation's equity. If shareholders are dissatisfied with the corporation's performance, they can vote for a change in management.

Why invest in stocks?

The main reason that investors buy stock is to seek capital appreciation and growth. Although past performance is no guarantee of future results, stocks have historically provided a higher average annual rate of return over long periods of time than other investments, including bonds and cash alternatives. Correspondingly, though, stocks are generally considered to have more volatility than bonds or cash alternatives.

Can you lose money?

Yes, you can. There are no assurances that a stock will increase in value. Several factors can affect the value of your stocks:

- Actions of investors: If a large number of investors believe that the nation is entering a recession, their actions can affect the direction of the stock market
- Business conditions: A new patent, an increase in profits, a pending merger, or litigation could affect investor interest and stock prices
- Economic conditions: Employment, inflation, inventory, and consumer spending influence the potential profit of a company and its stock price
- Government actions: Decisions on interest rates, taxes, trade policy, antitrust litigation, and the budget impact stock prices
- Global economy: Changes in foreign exchange rates, tariffs, or diplomatic relations can cause stocks to go up or down

All investing involves risks, and there can be no assurance that any investing strategy will be successful. However, understanding these factors can help you make sound investment decisions and keep losses to a minimum.

What are the different classifications of stocks?

Stocks are often classified in the following ways:

- Growth stocks have earnings that are increasing at a faster rate than the market average. These are usually in new or fast-growing industries and have the potential to give shareholders returns greater than those offered by the stocks of companies in older, more established industries. Growth stocks are the most volatile class of stock, however, and may be just as likely to go down in price.
- Value stocks are those of companies with good earnings and growth potential that are currently selling at a low price relative to their intrinsic value. Due to some problem that may be only temporary in nature, investors are ignoring these stocks. Since it can take quite some time for their true value to be reflected by their price, value stocks are usually purchased for the long term.
- Income stocks are generally not expected to appreciate greatly in share price, but typically pay steady dividends. Utilities are an example of companies that have historically been considered income-oriented.
- Blue chip stocks are the stocks of large, well-known companies with good reputations and strong records of profit growth. They also generally pay dividends.
- Penny stocks are very risky speculative stocks issued by companies with short or erratic performance histories. These stocks are so named because they sell for under $5 per share. Their low price appeals to investors willing to assume a total loss in exchange for the potential for explosive growth.

It is usually best to diversify among the different classifications and not own stock in just one or two companies or industries (though diversification alone cannot guarantee a profit or ensure against a loss).

How are stocks bought and sold?

During an initial public offering (IPO), new issues of stock are sold on the basis of a prospectus (a document that gives details about a company's operation) that is distributed to interested parties. Investment bankers or brokerage houses buy large quantities of the stock from the company and sell them to investors. After the IPO, the stock may trade on a stock exchange or over the counter.

Normally, stock is purchased through a brokerage account. The buy order you place will be directed to the appropriate stock exchange. When someone who owns the stock is willing to sell at the price you are willing to pay, the sale takes place. A commission or fee is charged on your transaction.

Stock certificates may be transferred from one owner to another since they are negotiable instruments. The certificates are issued in the buyer's name or, more typically, held by the brokerage house in street name (i.e., the brokerage firm's name) on behalf of the investor. The advantage of a street-name registration is that if you decide to sell, you do not have to sign and deliver the stock certificates before the sale can be completed. And you don't have to worry about losing the stock certificates.

How do you set up a brokerage account?

You will need to complete a new account agreement and make three important decisions:

Who will make the investment decisions? You will — unless you give discretionary power to your broker or agent. Discretionary power allows a broker or agent to make decisions based on what he or she believes is best for you. Unless you limit the broker's or agent's discretion, this may be done without consulting you about the type of security and number of shares involved, or about the time and price at which to buy or sell. Do not give discretionary power to your broker or agent without seriously considering if it is right for you.

How will you pay for the stock? A cash account requires you to pay for each stock purchase in full at the time you buy it. A margin account allows you to borrow money from the brokerage firm. Securities that you own are held as collateral, and interest is charged on the loan. If the account value falls below the specified amount required to maintain the loan (even as the result of a one-day market decline), you must pay down the loan balance to an amount determined in relation to your new account balance. This is known as a margin call and can potentially require the payment of a sizable amount of money.

What level of risk can you handle? You will be asked to specify your investment goals in terms of risk. Choices such as income, growth, or aggressive growth may be given. Make sure you understand the meaning of each term, and be certain that the level of risk you choose truly reflects your ability to handle risk. Any investment your broker or agent recommends should be based on the category of risk you selected.

Read the account agreement

Never sign a document without reading and fully understanding it. Early precautions can prevent later misunderstandings.

Keep good records of:

- Documents you sign
- Documents outlining the details of an account or investment
- Periodic account statements
- Transaction confirmations
- Documents verifying an account error was corrected
- Correspondence with your broker or agent

Review these as soon as you receive them. Discuss any discrepancies you find with your broker or agent at once, and follow up on any actions taken until you are satisfied. Never allow your broker or agent to mail statements and transaction confirmations to someone other than you. It's important that you check the accuracy of your own accounts.

Be patient

Some stock investors have made money quickly. But they are the exception rather than the rule. Investing in stocks requires a long-term outlook. Read books, attend seminars, and take advantage of professional advice. Education, good judgment, common sense, and above all, patience increase your chances of achieving your goals.

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