

## 14.2: Investing and Trading

### Learning Objectives

1. Identify the important differences between types of investment agents.
2. Describe the different levels of service offered by investment agents.
3. Analyze the different fee and account structures available to investors.
4. Differentiate the types of trading orders and explain their roles in an investment strategy.

The discussion of investment so far has focused on the ideas behind your investment plan, but to be useful to you, your plan has to be implemented. You have to invest, and then, over time, trade. How do you access the capital markets? How and when do you buy, sell, or hold?

To answer these questions you need to know the types of agents who exercise trades in the financial markets; the types of services, accounts, and fees they offer; and the kinds of trading orders they execute on your behalf.

### Agents: Brokers and Dealers

The markets or exchanges for stocks, bonds, commodities, or funds are membership organizations. Unless you are a member of the exchange, you cannot trade on the exchange without hiring an agent to execute trades for you. Trading essentially is buying and selling.

As you've read in Chapter 12, a **broker** is an agent who trades on behalf of clients to fulfill client directives. A **dealer** is a firm that is trading for its own account. Many firms act as **broker-dealers**, trading on behalf of both clients and the firm's account. Many brokers, dealers, and broker-dealers are independent firms, but many are subsidiaries or operations of large investment banks, commercial banks, or investment companies.

Firms may offer different levels of brokerage services:

- **Discretionary trading** means that the broker is empowered to make investment decisions and trades on behalf of the client.
- **Advisory dealing** means that the broker provides advice and guidance to the client, but investment decisions remain with the client.
- **Execution-only** service means that the broker's only role is to execute trades per the investor's decisions.

Almost all brokerages provide online and mobile access, and most allow you to access your account information, including trading history, and to place orders and receive order confirmations online. Some discount brokers operate only online, that is, they have no retail or storefront offices at all. This allows them to lower costs and fees. Most brokerages still send out hard copies of such information as well. Some also provide research reports and tools such as calculators and data for making asset allocation decisions.

### Fees

As firms offer different levels of service, their compensation or fee structures may vary. A broker is compensated for executing a trade by receiving a commission based on the volume of the security traded and its price. A discount broker may offer lower commissions on trades but may provide execution-only services.

A firm may offer all levels of service or specialize in just one. Large discount brokers such as Fidelity, Scottrade, or Charles Schwab may provide a full range of services along with execution-only services that charge lower commissions on trades. Other discount brokers and online-only brokers may charge a lower flat fee per trade, rather than a commission on the amount of the trade. Some firms charge a commission on trades and a fee for advisory or discretionary services. The fee is usually a percentage of the value of the portfolio. Some charge a flat fee for a quarterly or annual portfolio check-up and advisory services.

Both the commission-based and the fee-based compensation structures have critics. The commission-based structure results in more compensation for the broker (and more cost for you) if there are a greater number of trades. This can lead some brokers to engage in excessive trading, called **churning**—an unwarranted and unnecessary amount of trading in your account for which the broker is being compensated.

On the other hand, a fee structure based on a percentage of the value of the assets under management can reward a broker for doing nothing. If the economy expands and asset values rise, the value of the portfolio—and therefore the broker's compensation—may

rise without any effort on the broker's part.

The most economical recourse for an investor is to find a broker who charges a flat fee for advisory services, independent of portfolio size, and discount fees for commissions on trading. The costs of investing and trading depend on how much trading you do and how involved you are in the investment decisions. The more of the research and advisory work you do for yourself, the less your costs should be.

## Brokerage Accounts

Two basic types of brokerage accounts are cash accounts or margin accounts. With a **cash account**, you can trade using only the cash you deposit into the account directly or as a result of previous trades, dividends, or interest payments. The cash account is the most common kind of brokerage account.

With a **margin account**, you may trade in amounts exceeding the cash available in the account, in effect borrowing from your broker to complete the financing of the trade. The investor is said to be “trading on margin.” The broker usually requires a minimum value for a margin account and extends credit based on the value of the cash and securities in the portfolio. If your portfolio value drops below the minimum-value threshold, perhaps because securities values have dropped, then you may be faced with a **margin call**. The broker calls on you to deposit more into the account.

Investors pay interest on funds borrowed on margin. As regulated by the Federal Reserve, the amount of an investment financed by debt or bought on margin is limited. The **margin requirement** is the percentage of the investment's value that must be paid for in cash.

**Custodial accounts** are accounts created for minors under the federal Uniform Gifts to Minors Act (UGMA) of 1956 or the Uniform Transfers to Minors Act (UTMA) of 1986. The account is legally owned by the minor and is in his or her name, but an adult custodian must be named for the account. Otherwise, the owner of a brokerage account must be a legal adult. The account is created at a bank, brokerage firm, or mutual fund company and is managed by an adult for an underage child (as defined by the state).

Establishing a brokerage account is as easy as opening a bank account or credit card account. You will need a good credit rating, especially for a margin account, a reasonable source of income, and a minimum deposit of assets. Many brokers allow you to transfer assets from another brokerage account with minimal effort.

## Brokerage Orders

You need not be an expert in the arcane language brokers use to describe trades, so long as you understand the basic types of orders you can request. Say you want to buy a hundred shares of X Corporation's common stock. You call your broker and ask the price. The broker says that at this moment, the market is “50 bid-50.25 ask.” Stock exchanges are auction markets; that is, buyers bid what they are willing to pay and sellers ask what they're willing to accept. If the market is “50 bid-50.25 ask,” this means that right now the consensus among buyers is that they are willing to pay \$50 per share, while sellers are willing to accept \$50.25. The “bid-spread” or difference is 25 cents.

If you then place a **market order** to buy a hundred shares, the order will be executed at the lowest asking price—the least that the seller is willing to accept. In other words, you will pay \$50.25 per share, the asking price, to buy the stock.

You could also place a **limit order** to buy the shares when the price is lower, say \$45 per share (or to sell when the price is higher, say \$55), specifying how long the order is in effect. If the price goes down to \$45 (or up to \$55) within the period of time, then your limit order will be filled, and otherwise it will not.

When you buy a security, you are said to have a **long position** in that security; you own it. You could close out your position by selling it. When you “go long” in a security, you are expecting its value to rise, so that you can buy it for a lower price and then sell it for a higher price.

Alternatively, you could create a **short position** in the security by borrowing it from your broker, selling it, and then buying it back and returning it to your broker at some specified point in the future. When you “short” a security, you are expecting its value to decrease, so that you can sell it at a high price and then buy it back at a lower price.

Other specialized kinds of orders include a **stop-loss order**, where you direct that the stock be sold when it reaches a certain price (below the current price) in order to limit your potential loss if the value decreases. You can use a **stop-buy order** to buy a stock at a certain price (above the current price) if you have “shorted” a security and want to limit your loss if its value rises.

If you are following a “buy-and-hold” strategy, you are establishing positions that you plan to hold for a long time. With this strategy you probably will do well to use a market order. Over the long term that you hold your position, the daily fluctuations in price won’t matter.

## Summary

- A broker trades on behalf of clients; a dealer trades for its own account, and a broker-dealer does both.
- Brokers, dealers, and broker-dealers may be independent firms or subsidiaries of investment banks, commercial banks, or investment companies.
- Firms may offer several levels of brokerage services, defining their roles as active manager, advisor, and/or traders:
  - discretionary trading,
  - advisory dealing,
  - execution only.
- Brokerage fees are based on the level of service provided and may consist of
  - commissions on trading,
  - advisory fees based on portfolio value, or
  - a flat fee for management.
- Brokerage accounts may be
  - cash accounts,
  - margin accounts, or
  - custodial accounts.
- Trading orders allow you to better execute a specific trading strategy:
  - market orders,
  - limit orders,
  - stop-loss orders, or
  - stop-buy orders.

## Exercises

1. Read the information at the following sites about choosing an investment broker or brokerage firm:  
<http://beginnersinvest.about.com/od/choosingabroker/a/brokeraccount.htm> and  
[www.msmoney.com/mm/investing/...rage\\_firms.htm](http://www.msmoney.com/mm/investing/...rage_firms.htm). In My Notes or your personal finance journal, record the top ten questions about a broker or brokerage that will guide your choice. What answers will you be looking for? See how the investment industry evaluates brokers at <http://www.smartmoney.com/investing/economy/smartmoneys-annual-broker-survey-23119> and <http://www.moneybluebook.com/reviews-of-the-best-online-discount-brokers>.
2. What information (or inspiration) useful for personal finance can you get at Money Blue Book (<http://www.moneybluebook.com>)? How would you evaluate the Money Blue Book Web site as a source of financial news, information, and advice? In your opinion, how do sites such as Money Chimp (<http://www.moneychimp.com/>), Cool Investing (<http://www.coolinvesting.com/>), and Get Rich Slowly (<http://www.getrichslowly.org/blog/>) compare?
3. At the following Web sites, survey the argots, or “secret” vocabularies, that brokers use to discuss trades. From each glossary select five words relevant to you and their definitions to record in your personal finance journal or My Notes.
  - Stock Trading: <http://www.mytradingsystem.net/Glossary-trading-terms.html>
  - Bond Trading: [www.bondsonline.com/asp/trading/glossary.asp](http://www.bondsonline.com/asp/trading/glossary.asp)
  - Futures Trading: [www.webtrading.com/glossary.htm](http://www.webtrading.com/glossary.htm)
  - Currency Trading (Foreign Exchange, or FOREX): <http://www.fxwords.com>

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