How the Stock Market Works

Today, more people than ever have some of their money in the stock market. That's because they know that, over many years, stocks have offered investors higher returns than other types of investments.

You've probably heard people talk about whether the market is up or down—or how their stocks are doing. But has anyone ever explained to you how the stock market actually works? If not, chances are they weren't sure themselves. Read on, and you will soon be explaining it to them.

First Things First: What Is a Stock?

A share of **stock** is a small ownership stake in a company. When you buy stock, you become a **shareholder** or **stockholder.** Companies sell stock in order to raise the money needed to expand or improve their businesses. Businesses that raise **capital** in this way are called **public companies.**

Investors buy stock to obtain a **return** on their investment, just as you may deposit money in a savings account to earn interest. If you purchase the stock of a company that does well, you may earn a higher return than what you could earn from a savings account—and your money may actually grow faster.

How Can Stocks Help Your Money Grow?

Stocks can help your money grow in two ways. If the **share price** of your stock goes up, you can make a profit—also known as a **capital gain**—when you sell your shares. Of course, the share price can go down, and you can lose some of your money. Some stocks pay investors a **dividend,** which is a portion of the company's profits, on a regular basis.

Why Do Stock Prices Go Up or Down?

Stock prices are driven by **supply** and **demand.** If a company is doing well or its shares are selling at a fair price, many investors may buy its stock, creating **demand.** Demand drives up the price. If the company is not doing well—or the share price has been driven too high—investors may stop buying or begin selling. As demand drops, so does the price.

How Money Can Increase in the Market

Let's say you purchase 10 shares of XYZ stock at **$52** a share. Over time, the share price rises to **$78.50**, an increase of **$26.50** a share. If you sell at that point, you will make a profit of **$265.** If the stock pays a dividend, that amount will be added to your total return. A small transaction fee will be deducted from the proceeds by the firm that executes the transaction. You will also be responsible for taxes on the profit.

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Where Do You Go to Invest in Stocks?

Stocks are bought and sold at the **stock market.** This is where public companies seeking capital meet investors who seek profits.

America's first stock market opened in 1792, near an old buttonwood tree where stock traders used to meet. England's first stock market opened in 1773, in a former London coffeehouse.

At the stock market, each stock is registered with a particular **exchange**—such as the New York Stock Exchange (NYSE) and NASDAQ in the U.S., the Tokyo Stock Exchange (TSE) in Japan and the Toronto Stock Exchange (BC) in Canada. If you think of the stock market as a big shopping mall, then an exchange is a store that carries only certain brands of products. Today, there are stock markets all over the world. At each, stocks are bought and sold in a daily **auction** conducted by **stock traders** and **specialists.**

How Can You Invest in Stocks?

When someone wants to buy or sell stock, they usually go to a **brokerage firm** and talk to a licensed **stockbroker.** The stockbroker will **execute your trade**—that is, help you buy or sell stock—and charge you a small **transaction fee.** Stockbrokers who are **financial consultants** may also offer investment guidance.

What Is a Price/Earning Ratio?

Price = The current price of a share of stock.

Earnings = How much the share is worth based on the last business quarter's earnings.

Throughout the year, a business reports its earnings. This information is used as a factor to calculate how much a share of the company's stock should cost. But a stock may actually end up selling at a much higher price because prices fluctuate constantly as shares are bought and sold.

Some investors try to buy stocks with lower price/earning ratios—that is, stocks that are priced below or only slightly above their originally calculated cost. It's like waiting to buy a new pair of jeans until they go on sale.

No investment method is foolproof. Ultimately, a stock's price is determined by supply and demand.

Terms and Definitions

- Stock exchange: A marketplace where securities brokers and dealers meet to buy and sell securities for their customers.
- Capital gains: Money earned by selling stocks or other assets that appreciated in value since you purchased them. If you sell an asset after it has **decreased** in value, you have a **capital loss.**
- Dividend: A distribution of earnings to shareholders based on company profits. Dividends are usually paid out on a per-share basis every three months.

Did You Know?

- The first stock exchange began in 1602 in Amsterdam, Holland, where shares of the United East India Company were traded.[1]
- When the stock market does well and prices rise over a period of time, it's called a **bull** market. When prices decline for a period of time, it's called a **bear** market.
- Since 1926, stocks have increased in price an average of 10% a year.[2]

Time to Save℠ is an educational program developed by Merrill Lynch to promote financial literacy for children and young people, and their families.

[1] *A Dictionary of Finance* (Oxford: Oxford University Press, 1993), page 278.
[2] Reprinted from Merrill Lynch's *Brain Quest Money Matters.*

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