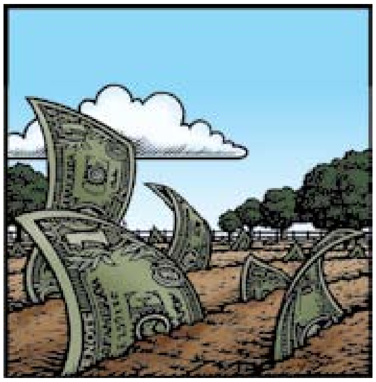
Swing HI, Swing LO

Causes of Stock Price Fluctuations

Objective A

Great Expectations



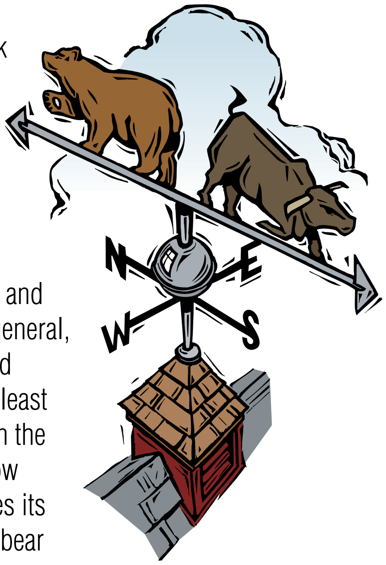
How do you get your money to grow—I mean, really grow? You could put your cash into a savings account, a money market account, or a certificate of deposit. You could even purchase bonds. Better yet, you could put your money into stocks, expecting it to grow *significantly* over a long period of time.

As a long-term investor, you don't want to get caught up in day-to-day stock price changes. Both up-to-the-minute price information and easy access to discount brokers tempt you to make snap decisions—encouraging you to risk your money in the short term. But, you don't need to respond quickly to the natural rise and fall of prices, because you're investing for the long term. And, of course, you expect your long-term stock investments to increase.

Running in circles

When it comes to your stock investments, your expectations drive your actions. In fact, expectations play an important role in how the stock market works, overall. When investors expect companies to grow, they buy stocks—so they can be part of the action. When investors expect companies to slow down, they hesitate to purchase stocks—because they don't want to lose any money. It's this cycle of growing-and-slowing that brings about the market's cycle of rising and falling stock prices.

Supply and demand. You can think of the market's cycle in terms of supply and demand. In the market, stocks are available in a limited supply. The more popular (or "in demand") stocks are, the higher their prices. And, the less popular, the lower their prices. A stock's level of popularity reveals whether investors have high or low expectations.



Bull and bear. You can also think of the market in terms of the "bull" and the "bear." Each animal represents the direction in which the market is headed. If stock prices are rising, it's a **bull market**, and more products will be purchased. If stock prices are falling, it's a **bear market**, and fewer products will be purchased. In general, bull (or bear) markets are characterized by sustained growth (or decline) of at least 15–20%. You can distinguish between the two types of markets by visualizing how each animal kills its prey. The bull uses its horns in an upward motion, while the bear swipes its paws downward.

Who's asking?

What, then, is a stock's price? Simply put, the price of a stock is the amount that buyers are willing to pay for it. And, what they're willing to pay depends on how optimistic they are. Some stocks sell for more than their book value because investors have high expectations for the company's future performance. Other stocks sell for less because expectations are not as great.

The **ask price** is the sell price—or the lowest price the seller will *sell* the stock for. The **buy price** is the bid price or the highest price the buyer will *buy* the stock for. When the two are equal or overlapping, there can be a sale/purchase. When they're not

Objectives:

A. **Explain how stock prices move in the stock market.**

B. **Discuss causes of stock price fluctuations.**

Objective A

equal or overlapping, something has to change. The buyer has to be willing to pay more, or the seller has to be willing to sell for less.

Consider a toy manufacturer whose stock is priced at $35 a share (the ask price). Investors who believe the company has a bright future are willing to pay the $35. Those who believe the firm has a *brilliant* future might be willing to pay $37 (the buy price). Since the prices are equal or overlapping, a purchase is possible. But, there can't be a purchase when an investor is willing to pay only $32.

Big ups and downs

With a bull market, stock prices are rising, overall. Some stock prices, however, rise much higher than the rest—and fall much lower, later on. That's due to volatility. **Volatility** compares how much "rollercoaster" action a stock demonstrates in relation to the stock market as a whole. If a particular stock is rising (or falling) right along with the market, it's not very volatile. But, one that rises higher than (or falls lower than) the market is pretty volatile, especially if it's *much* higher or lower. Volatile stocks mean higher risks for investors—and potentially higher returns.

Is the market efficient? Some investors think so. They think that investors have complete information and that stock prices accurately reflect a company's value. Others disagree. They say that some investors have *incomplete* information about a company—and that stock prices, especially in the short term, do not necessarily reflect a company's actual value.

Objective B

Going Up—or Down?

You know why you put your money into stocks (to grow it), but do you know why stock prices move up and down? I mean, do you understand what influences a stock's price? You might be able to name some of the influences without help. But, just in case they're not on the tip of your tongue, let's review what brings value to your stock—according to these categories:

- The company
- Communication about the company
- The company's industry
- The economy
- World events

The company

A business can positively influence its own stock right from its company headquarters by doing things such as: meeting its earnings projections, hiring experienced executive-level managers, introducing well-researched products, and adjusting its business model when necessary.

Earnings projections. Every quarter, a business predicts how much it will earn for the coming quarter. Investors pay close attention to the earnings projections because they show what the people running the company expect from the business in the short term. But, it's not short-term earnings that drive the company's success, or its stock price, overall. It's long-term earnings.

With this in mind, long-term investors realize that missing a quarterly earnings goal might send the company's stock price down, temporarily. This can happen even when earnings projections are revised before the end of the quarter. When Tyco International Ltd. had to cut its forecast for the first quarter of 2005 due to a weakness in one of its companies, Tyco's stock price fell almost 11 percent, right away.

On the flip side, if a company reaches or exceeds its earnings projections, stockholders won't be as willing to sell, but other investors *will* be more willing to buy—moving the price upward.

Executive management. The executive management team usually makes the earnings predictions. This team is made up of the CEO, vice presidents, and managers at the highest levels. Since they make the all-important earnings projections, members of upper management can inspire or reduce investors' confidence in the company. And, as you might guess, hiring a new executive often brings about a positive or negative stock-price response.

Why are executive managers so influential? New managers usually bring a new strategy for achieving greater earnings. And, if they have a high level of expertise, new managers can significantly further the company's growth. When investors are confident that new executives will be successful, they are willing to purchase stock—and the stock price rises.

New products. Of course, new products can get investors excited about future success. When a video-game company comes out with a new gaming "toy," the company and its stockholders become confident they'll gain an edge in the lucrative video-game market. This expectation of success spreads to other investors—moving the stock's price upward.

Business model. In addition, stock prices can move when a company changes its business model—or the way it makes money. For example, Krispy Kreme changed its business model when it moved from selling doughnuts exclusively in stand-alone stores to selling them through grocers. Such a fundamental change impacts a company's stock price immediately.

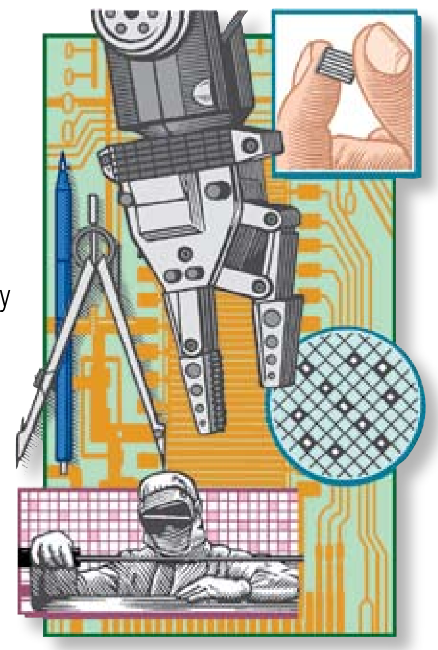
Acquisitions, in particular, can move stock prices right away. As the acquiring company takes on more risk (by acquiring another company), its stock price lowers. And, as the acquired company takes on "potential" through the acquisition, its stock price rises. This happened when Hewlett-Packard (HP) acquired Compaq in 2002: When word got out about the acquisition, HP's stock price dropped.

Communication about the company

All of these things—earnings projections, changes in management, new products, and business-model revisions—can affect the stock price of a company from *within*. (You can call them company-specific changes, if you want.) But, companies have some help in communicating these changes. In fact, investors and analysts play a big role in letting people know what's going on.

When we talk about investors, in this case, we're including both individuals and institutions. Individuals include people (like you and me!) who purchase stocks on their own or through a professional. Institutions include mutual fund managers, large investment firms, or significant holding companies. If a few million investors behave the same way toward (or against) a particular stock, its price will probably move. And, if a significant institution buys or sells a number of shares in a corporation, other investors will pay attention, with some of them following suit.

In addition, analysts are continually examining the facts and giving their opinions about ground-breaking technology, growing industries, and cutting-edge business models. And, of course, they think we should purchase some of the "hottest" shares for ourselves. Since many of us *do* listen and obey, what the analysts say can affect stock prices.



One more thing: Being added to, or removed from, an index can make a difference, too. (Indexes, such as the S&P 500, track the averages of a select number of business stocks.) Stock prices are influenced because many investors think that being added to an index is a sign of good things to come—and that falling off the list means something is wrong.

The industry

Outside forces—in the industry, the economy, and the world—can affect a company's stock price.

When an industry is growing as a whole, many of the industry's companies will see earnings improvements. Similarly, when there's a negative trend, earnings problems develop for many companies inside the industry. Those who work for an airline know this all too well. They have seen the industry's earnings, and jobs, suffer when people fly less.

In addition, competitors can make waves by coming into, or leaving, an industry. You know how this works in a limited location: If a small town has one landscaping business, adding a competitor causes the first firm some financial trouble. In the same way, adding some competitors to an entire industry definitely stirs things up. Consider what would happen if a relatively new business suddenly introduced a newer, *better* way to listen to music—quickly reducing the demand for iPods. Do you think the stock price of Apple Computer, Inc., would dip, at least temporarily? It would if investors were expecting the new competitor to accomplish great things in the technology and/or music industries.

The economy

On a larger scale, the economy affects stock prices in an important way. Just as stock prices go through bull and bear markets, the economy in general goes through periods of inflation and recession. It's easy to understand the connection when you think about people's actions in a depressed economy. They're simply spending less, putting downward pressure on companies' earnings. Inflation eats up investors' extra money, and stock prices usually suffer. On the other hand, when employment is high and people have money to spend, stock prices usually rise.

Some stocks are more closely tied to the economy than others. These are called **cyclical stocks**. Typically, these stocks are from companies whose products and services are discretionary—that is, people have a choice about whether to buy them. For example, when employment is high and people have money to spend, they can build new homes, and the stock prices of construction-related firms rise. But when the economy tightens spending, people cut back on building new homes, and stocks in the building industry suffer. The automobile industry operates in a similar way. People spend money on new cars, trucks, and motorcycles when they have jobs—but not when jobs are hard to find. Other industries with cyclical stocks include the airline industry, the restaurant industry, and the clothing-retail industry. Non-cyclical industries, with more constant demand, include utilities, health care, and food.

You can guess that the economy is going to expand if you see these economic indicators:

- Rising Gross Domestic Product (GDP)
- Low inflation
- Low interest rates
- Low unemployment rates
- Federal government budget surplus

And, you can predict the economy is going to contract when you see that:

- Companies are making less money.
- Inflation is high.
- Interest rates are high.
- Unemployment is high.
- There's a budget deficit in the federal government.

It doesn't take a rocket scientist to link certain government actions to what happens with stock prices. When interest rates are adjusted, you know that lending investments are influenced, either positively or negatively. In the same way, regulations can affect the price of a stock—in a good way, or not. Take the automobile industry, for instance. When the Environmental Protection Agency (EPA) requires a vehicle's exhaust to contain less than a certain amount of harmful substances, automobile manufacturers must find a way to make that happen. If the task is costly, the company's stock price can dip as investors respond to the news.

World events

What happens around the world can affect stock prices, too. Consider the losses of September 11, 2001, the Asian tsunami of 2004, and the hurricanes that hit the United States in 2005. Whenever an event, whether natural or political, affects investors' decisions to buy or sell stock, it has an influence on the stock's price. You might see investors buying into construction-related businesses, for example, when an area needs to be rebuilt.