Capitalism Lesson 14: The Stock Market

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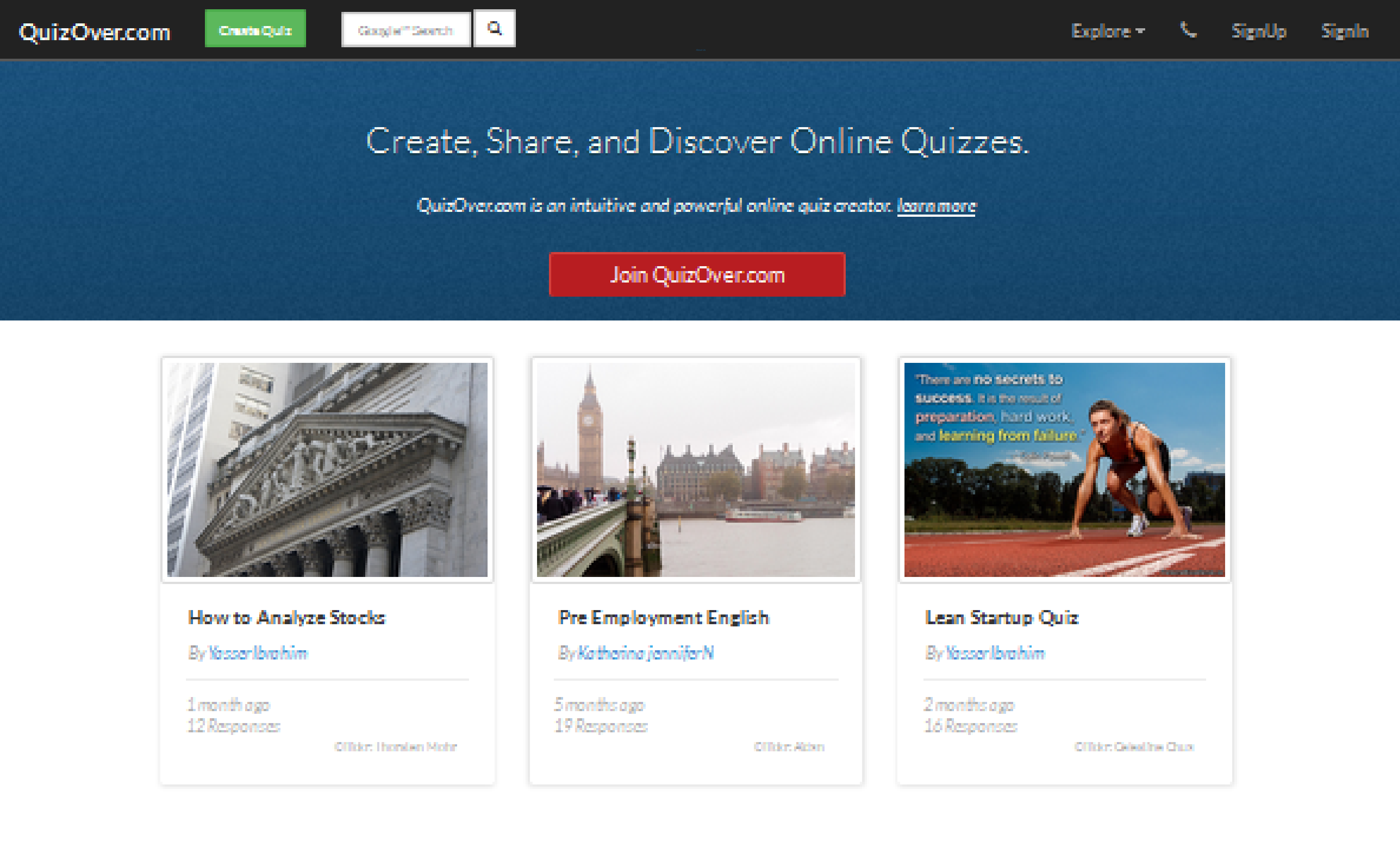
Published 2014



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4. Chapter: Lesson 14: The Stock Market

1. Lesson 14: The Stock Market Questions

4.1.1. If Jim owns 200 shares of a corporation, can we figure out how much...

Author: Robert Murphy

If Jim owns 200 shares of a corporation, can we figure out how much of the corporation Jim owns?

- No, we need to know the total number of shares as well, in
  order to calculate Jim's percentage. The point of this question
  is to make sure the student realizes corporations have different amounts of stock shares.

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4.1.2. What are the two basic options a corporation can take to raise new ...

Author: Robert Murphy

What are the two basic options a corporation can take to raise new funds?

- The corporation can issue debt (i.e., sell bonds) or equity (i.e., sell new shares of stock).

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4.1.3. Who gets first dibs on the earnings of a corporation—the bondholder...

Author: Robert Murphy

Who gets first dibs on the earnings of a corporation—the bondholders or the stockholders?

- The bondholders. The stockholders are residual claimants, meaning they are only entitled to the assets of the corporation after everyone else (suppliers, lenders, laid-off employees filing a lawsuit, customers demanding a refund, etc.) has been satisfied.

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4.1.4. If a corporation is highly leveraged, will its stock be more likely...

Author: Robert Murphy

If a corporation is highly leveraged, will its stock be more likely to appeal to a conservative or an aggressive investor?

- The "correct" answer is the aggressive investor. In reality even a conservative investor might own a small portion of a highly leveraged company, so long as the investor diversifies his holdings across many corporations. But in this basic question we are just trying to get the student to understand that—other things equal—more leverage tends to magnify potential gains and potential losses.

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4.1.5. *How do successful speculators reduce the volatility of stock prices?

Author: Robert Murphy

*How do successful speculators reduce the volatility of stock prices?

- A stock price is volatile when it bounces around a lot, rather than moving within a narrow band. Stock speculators, if they are profitable, tend to reduce the band in which a stock price moves. If a stock price is above where it "should" be, the astute speculator will sell it, pushing down the price. If the price is originally too low, the astute speculator will buy the stock, pushing up the price.

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4.1.6. Explain why companies might want to raise outside funds, rather tha...

Author: Robert Murphy

Explain why companies might want to raise outside funds, rather than financing any desired spending out of profits.

- A company might see an opportunity that it needs to seize quickly.
  For example, if a company thinks it can double its profits by
  building another $10 million factory, but only has $1 million in net
  income each year, it may want to raise the needed money from
  outsiders rather than wait (at least) ten years before expanding.
  Sample Partial Credit Answer
  A company thinks it can make more money.

4.1.7. Discuss the distinction between a corporation raising new funds by ...

Author: Robert Murphy

Discuss the distinction between a corporation raising new funds by issuing debt versus stock.

- When a corporation issues debt, its leverage increases and it is more vulnerable if its assets lose value. The upside is that if the corporation does well, it only owes the bondholders a fixed amount of interest payments. When a corporation issues stock, outsiders now share in the profits or losses, which cushions the blow but also reduces the potential gains to the original owners.
  Sample Partial Credit Answer
  Issuing debt is riskier.

4.1.8. Explain how speculators actually regulate the stock market in a hea...

Author: Robert Murphy

Explain how speculators actually regulate the stock market in a healthy and non-interventionist way.

- A speculator buys low and sells high, or short-sells high and buys back low. A successful speculator therefore bids up underpriced stocks, and pushes down overpriced stocks. Successful speculation therefore makes stock prices less volatile for other, less knowledgeable investors.
  Sample Partial Credit Answer
  Speculators correct mispricings in the stock market.

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4.1.9. In common discussions, what is the difference between an investor a...

Author: Robert Murphy

In common discussions, what is the difference between an investor and a speculator in stocks?

- People typically think of an investor as someone who intends to hold a stock for a long time either as part of a general strategy or because the company seems dependable. A speculator, on the other hand, is someone who looks to get in and out relatively quickly, after an anticipated price move.
  Sample Partial Credit Answer
  A speculator thinks the original price of the stock is wrong.

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