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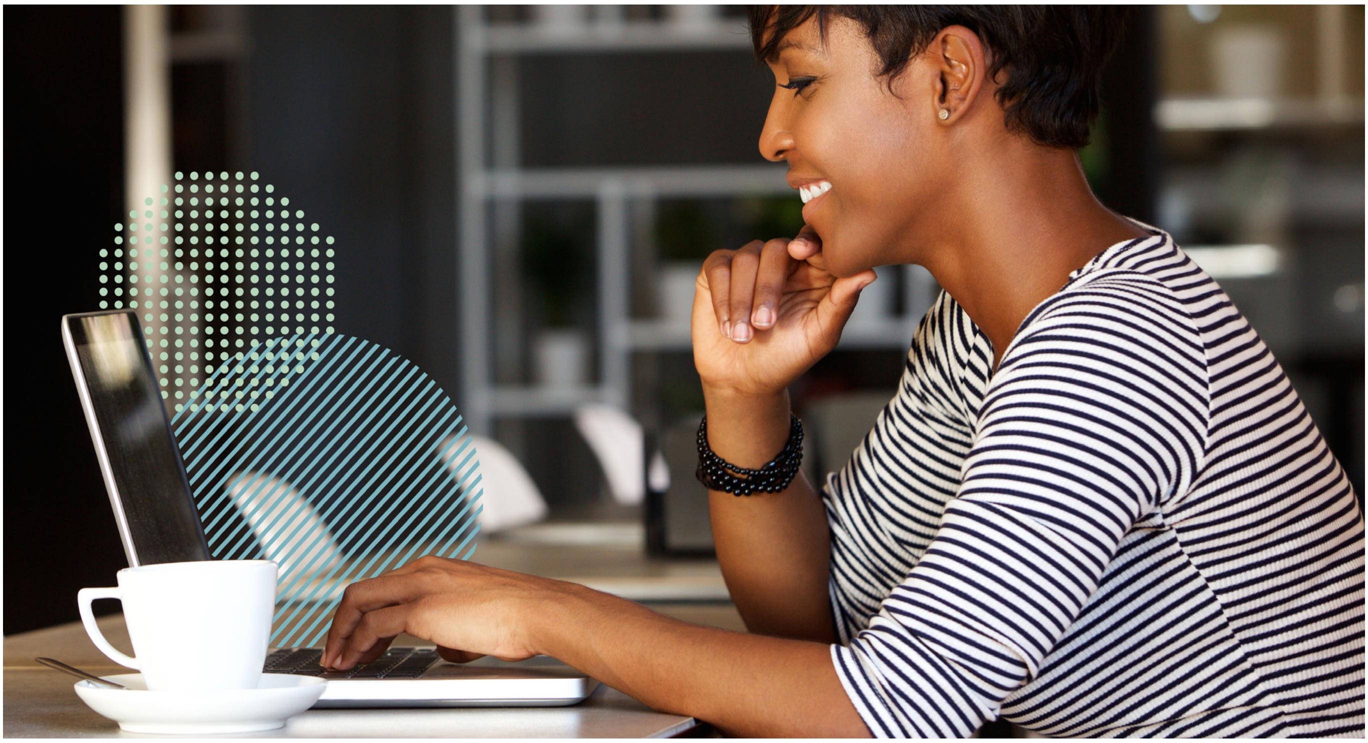


A guide to share dealing

Buying and selling shares is something that everybody should understand. The good news is that, despite all the jargon, dealing in shares is actually very easy. John Stepek from MoneyWeek explains how the stock market works and how you can start to be a regular investor.

If you want to have a decent retirement, you will almost certainly have to invest some of your money in the stock market. Dealing in shares (also known as stocks, or equities) is actually very easy. In fact, by the time you've finished reading this short article you should know enough to get started.

How does the stock market work?

All companies need money, for reasons that range from funding expansion to turning around an ailing business. Borrowing is one way to get this money; another is to sell part of the company.

A stock market (or stock exchange) provides one way for a company to do this, by providing a market where people who want to buy shares in a company are matched with people who want to sell them. The main – though not the only – stock market in the UK, is the London Stock Exchange.

The FTSE 100 is a list – or index – of the 100 biggest companies traded on the London Stock Exchange.

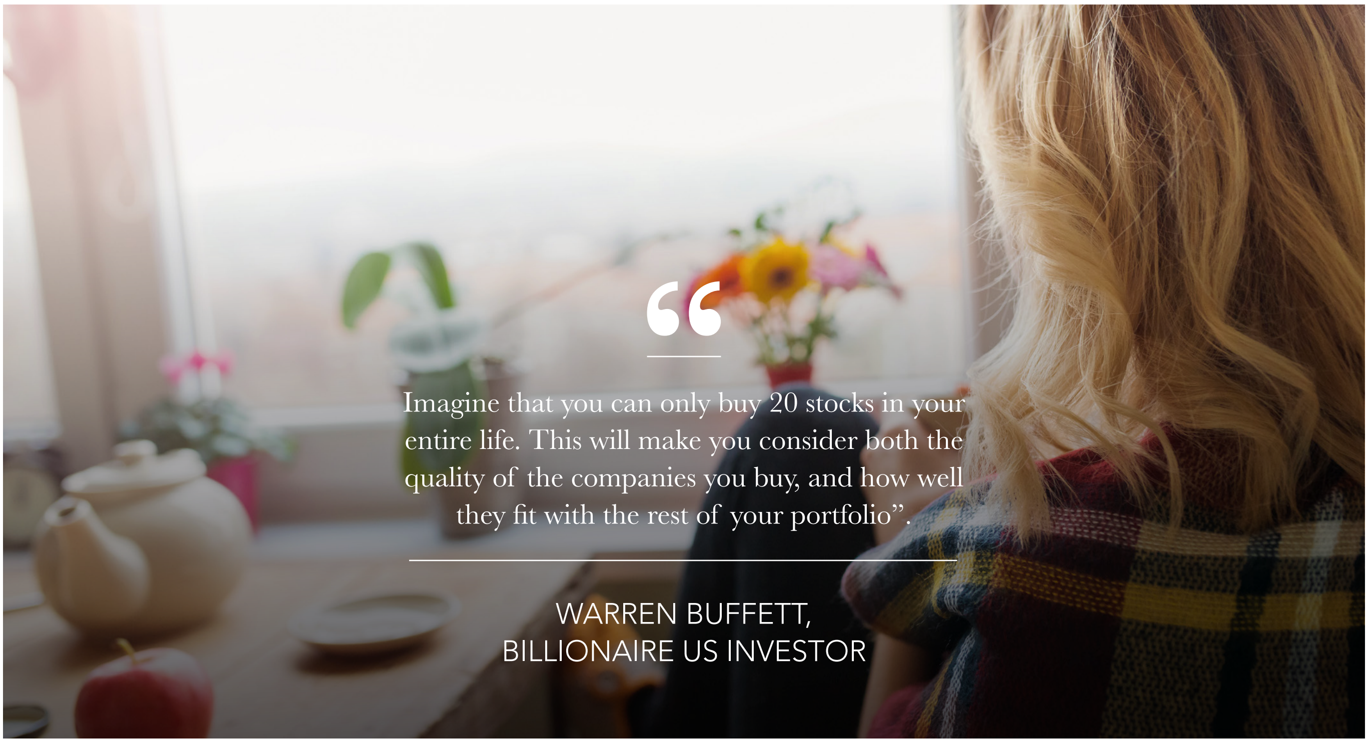
The price of a company's shares, like anything else, is set by supply and demand. When more people want to buy a stock than want to sell, the price will rise, and vice versa. As owners of the company, shareholders are entitled to attend and vote at the annual general meeting, and also to receive any dividends paid out by the company.

Unlike a savings account, the value of money invested in shares can go down as well as up, as the tech boom and bust of the late nineties showed many investors to their cost. But while a good savings account will pay enough interest to protect your money from inflation, it won't do much more than that.

If you want to save a decent sum for your retirement, you have to make your money grow ahead of inflation. And studies suggest that – over the long-term – the returns on shares beat those on savings accounts.

How to buy and sell shares

You probably already own shares. If you have a company pension, it'll be at least partly invested in shares. Or you may be buying shares in your employer, through a save-asyou-earn scheme. If you want to deal in shares directly, there are a number of options, all of which will involve going through a stockbroker.



Certificated holdings: With a ‘certificated’ account, you will receive your own paper share certificates. This means that your name will appear on the company’s share register, and you will receive a copy of the annual reports and have the right to attend and vote at the annual general meeting (AGM). But there are disadvantages. You have to keep the certificates safe, and when you want to trade, you have to send the certificates back to the broker. Most brokers will also charge more for this service, due to the inconvenience of handling the paper certificates.

Broker nominee account: This is a common type of service. You do not receive a share certificate – instead the shares are held electronically by your broker on your behalf in a “nominee”.This makes trading more convenient, and cheaper than holding paper shares, but it does mean that the broker’s name appears on the company’s share register, rather than your own.

While this means that your details are not in the public domain, it also means that you do not automatically receive a copy of the annual reports, or have the right to attend and vote at the AGM, though these can be arranged.

Corporate sponsored nominee (CSN): A third option is to invest via a corporate sponsored nominee. In this case the nominee is sponsored by the company you are investing in, and so although your name will not appear on the share register, the company will ensure you receive the annual report and can participate in general meetings. They are mainly offered on larger companies, but you can check if this service is available by contacting the company’s share registrar (the firm which maintains the list of shareholders), details of which should be available on the company’s website.

So what should you invest in?

It’s always tempting to chase the latest ‘hot’ investment stories. But you could easily lose a lot of money when such stocks fall out of favour. So it’s important not to put all your eggs in one basket. That means buying stocks across a number of business sectors (mining, banking, retail, and so on), so that if one part of the economy runs into trouble, you don’t lose everything. But building a suitably diverse portfolio can be expensive and time consuming.

An easier way to achieve this is through buying funds. Funds pool money from lots of investors, which is then used to buy a range of shares, or other assets, giving broad exposure regardless of how much money you have to invest.

Active vs. passive

There are two key styles of fund – actively managed funds, and passive, or tracker funds. An active fund manager tries to beat the market by buying stocks that he or she thinks will rise by more than the wider market. So for example, if the FTSE 100 rises by 5% one year, the fund manager will aim to return more than 5%. A tracker fund simply aims to track the performance of the index on which it is based. So if the FTSE 100 falls by 4%, the tracker should fall by around 4% too.

Active management may sound like the better option, but the problem is that very few fund managers actually manage to beat the market consistently over a long period of time. And employing a fund manager is an expensive business – fees on actively managed funds are typically between 1.5% and 2% a year, compared to less than 1% on the typical tracker. When you’re saving over the long term, these extra fees can make a big dent in your savings.

Basic fund types

There are three basic types of fund: unit trusts or open-ended investment companies (OEICS); investment trusts (or closed-ended funds); and exchange-traded funds.

Unit trusts: these are not listed on the stock market. You buy in through a stockbroker, fund manager or fund supermarket at a price per unit based on the value of the underlying investments. These funds tend to have the highest charges.

Investment trusts: these are listed on the stock market, so the price of their shares rises and falls with demand, not with the price of the underlying investments. This means an investment trust often trades below its underlying value (net asset value, or NAV). This is known as ‘trading at a discount.’ If the discount is 10%, then you are effectively getting £1 worth of NAV for 90p. Annual fees also tend to be lower than for unit trusts.

Exchange-traded funds (ETFs): these stock-market listed funds simply track the performance of a specific stock market or sector. Annual fees are among the cheapest (in the range of 0.35% to 0.75%) and there is a wide range to choose from, tracking everything from the FTSE 100 to the investments such as commodities.

Investment Timings

You might be wondering how best to time your investments. There’s a simple answer – don’t.

It’s virtually impossible to call the bottom of a market, or to sell at the top. Rather than investing a lumpsum, you could consider investing a regular amount each month, ‘drip-feeding’ the money into the market.

This means that when the market is falling, you'll get more units for your money, so that over the longer term, the cost of your investments will average out, smoothing out the ups and downs in the market.

Developing your stock-picking skills

If you do decide you want to start trading individual shares, then how should you go about it? Warren Buffett, the billionaire US investor, says you should imagine that you can only buy 20 stocks in your entire life. This will make you consider both the quality of the companies you buy, and how well they fit with the rest of your portfolio. He also believes in sticking to companies you understand. Buffett avoided the entire tech stock boom and bust because he didn't understand how tech stocks made money (in the end of course, most didn't).

But even if a company is a good business, that doesn't mean its shares are good value. It might be making lots of money, but he shares may already be pricing that in.

There are lots of ways to value a company. Two good starting points are the dividend yield, and the price to earnings (p/e) ratio. You can find these ratios on most share-dealing websites.

The dividend yield is the annual dividend paid per share, expressed as a percentage of the share price. So if the share price is £1, and the annual dividend is 5p, the dividend yield is 5%. This allows you to compare the return on the share with returns on similar stocks.

Generally, the faster growing the stock, the lower the dividend yield. So for example, the yield on a relatively low-growth stock, such as a water utility, might be higher than the yield on a company which is expected to grow quickly, such as a technology stock.

If a company's yield seems unusually high compared to its peers, that doesn't necessarily mean it's a bargain. If the firm is facing harder times ahead, it's possible that investors are concerned that the dividend will be cut, and the share price is reflecting that.

The other key valuation measure, the p/e ratio, is the price of the share divided by earnings, or profits, per share. The higher the p/e, the more you are paying for future earnings.

Fast-growing stocks will generally have higher p/es; those whose growth is expected to be low and stable are likely to have low, single-digit p/es. A company with an unusually high p/e compared to its sector may be overly priced, or it may just be the strongest performer. An unusually low p/e could suggest the company is cheap – or it may be low because investors suspect that its profits are unsustainable and set to fall.

We hope you enjoyed this article from John Stepek, Deputy Editor for MoneyWeek.

To find out more information about share dealing, investing and corporate sponsored nominee services, or to begin share dealing right now, visit our website for our secure and easy to use investment products.

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