thesharecentre:
simply easier

introduction to trading

Your guide to
buying and selling
stock market investments

welcome to the world of trading

If you've decided that you're ready to take your first steps into investing in the stock market, then this guide is for you.

We'll take it as read that you understand that any potential investment reward comes with a degree of risk, and that prices can go down as well as up, meaning you might not get back what you originally invested.

Your first questions are probably going to be 'What do I buy?' and 'When do I sell?' This guide aims to provide the answers. We won't be giving you individual share tips – sooner or later all of those go out of date – but we will give you some guiding principles to operate by.

Let's start by looking at where shares sit in the broad spectrum of stock market investments.

The greater the potential reward, the greater the risk

In the stock market, there's no such thing as a racing certainty (and plenty of those end up coming in last anyway!) As someone once said, if it seems too good to be true, it probably is.

However, stock market investments cover a wide spectrum of risk. This ranges from derivatives at one end, where it's all too easy to lose your entire investment, to money market funds at the other end, which are not too distant relations to conventional savings accounts.

It doesn't help that there's a fair bit of jargon that goes with the world of investing. Derivatives, for a start, not to mention Exchange Traded Funds, Exchange Traded Commodities, Investment Grade Corporate Bonds, OEICS and plenty more. All of which can make a potentially daunting field seem even more mysterious.

But don't worry. A little basic knowledge is all you need to take your first step. And many of the more obscure investment categories aren't really relevant to the novice investor.

The Basics

So let's focus on the four core types of investments that you're most likely to be considering.

Shares

You can buy and own shares of an individual company yourself. These are also known as equities.

Shares are the unit of investment in individual companies. The total value of a business that is listed on the stock market is calculated by multiplying the number of shares issued by the share price. So if there are 10 million shares, and the current price is £3 per share, then the company is valued at £30 million. This is what is known as the company's market capitalisation.

As we've seen, when it comes to buying and selling these different types of stock market investments they all work in slightly different ways.

Funds

These are managed investments where someone else, usually a fund manager, does the share picking for you. Unit Trusts and OEICS are both types of fund.

They are a good starting point for the new investor, as they enable you to spread your money across a broad range of companies, and you are drawing on the expertise of a professional investor.

Funds come in many shapes and sizes. Tracker funds aim to mirror the performance of a particular market – as measured by an index such as the FTSE 100 (the 100 biggest companies in the UK) – or sector. At the other end of the spectrum, emerging markets funds specialise in less well-established economies.

If you're choosing an actively managed fund as opposed to a tracker, you'll often be effectively investing in the skills of the fund manager. So it's worth looking at their track record, though this can't be taken as a reliable guide to their future performance.

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Funds are traded in units, and the price of the unit reflects the value of the underlying investments, rather than supply and demand. If more people want to invest in the fund, the fund manager simply issues more units.

Investment Trusts

These are shares in companies whose business is to invest in the shares of other companies. They have many similarities to funds, but you are buying shares in an investment company, not units in a fund.

Unlike funds, where the price is directly related to the value of the underlying investment, the price of investment trusts is determined according to supply and demand. So investment trust shares are said to trade at either a discount or a premium in relation to the value of the underlying holdings.

Bonds and Gilts

You'll sometimes hear these described as fixed income, in contrast to equities.

Bonds are you lending money to a company for a certain length of time, in return for an agreed rate of interest.

Gilts are the same thing, except you are lending money to the UK government.

Bonds and gilts are considered to be at the lower end of the risk spectrum, as your capital is returned to you at the end of the term – always assuming the company or government you are lending to does not go bust. Gilts are seen as the lowest risk of the two, because if the government defaults on its debts then we'll all have bigger things to worry about!

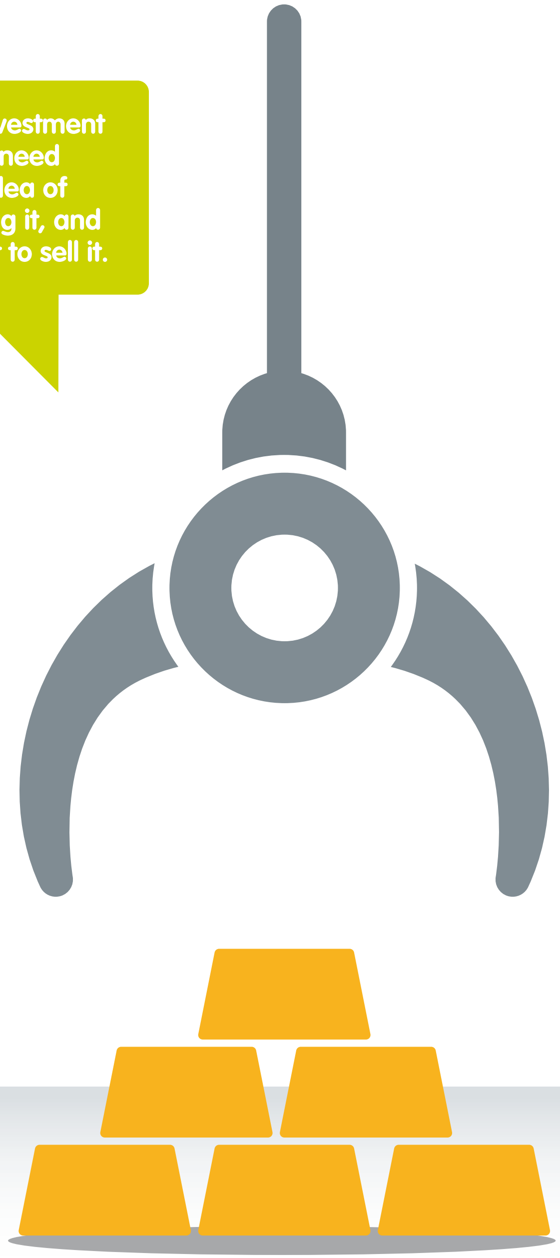
As lenders to a company, bond holders have a prior call on the business's assets if it gets into trouble, which is another factor that makes them less risky than shares. Independent ratings agencies such as Standard & Poor's and Moody's assess the risk of bonds, rating them from AAA for the very best, right down to 'junk bond' status.

But whichever investment you choose, you need to have a clear idea of why you're buying it, and when you'll want to sell it.

Bonds and gilts always revert to their issue price when they mature. So if you bought £100 of 10-year bonds, you would get £100 when you redeem them in 10 years. The maturity date won't always be fixed; some have a period of time within which the issuer has the option to repay your money.

In between, however, the price will fluctuate. Unlike shares, where the price is driven by the profit outlook, bond and gilt prices react to interest rates. Because they pay a pre-determined rate of interest, if interest rates go up the price will generally fall, whereas if interest rates fall the price will rise.

The exception is bonds and gilts where the return is linked to the rate of inflation or the Bank of England Base Rate. When interest rates rise these can become attractive.



Choosing an investment strategy

To improve your chances of investing successfully, it's important to have a strategy. This doesn't mean you need to become a market guru overnight. But it's better to have a plan – and stick to it – than acting purely on whim, or trusting to luck.

There's a wealth of literature and online advice available about different investment strategies. If you're thinking of becoming a regular investor, you'll probably want to do your own research and decide which approach is correct for you.

At its most basic, this could simply involve keeping an eye open, when you're out shopping, for retailers that seem to be doing particularly well. If you're looking for something a little more systematic, what follows will give you a broad overview of the most common strategies.

Investors who are seeking growth in the value of their shares, as opposed to just income from them, fall into two broad types. So before we consider the individual strategies you might employ, let's take a brief look at these types.

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Value investors

Value investors look for companies they feel are being significantly underrated by the market. One of the key measures for this is the price/earnings ratio (PE) – the share's price divided by its earnings per share. If this is lower than for other shares in the same sector, is there a good reason for this? Or can you see an opportunity that the market hasn't?

Growth investors

Growth investors take the opposite view. They are prepared to pay more now for companies they regard as offering the fastest growth. For them a high PE is a good thing – as long as they can see it is justified.

Thematic investing

A third category has grown in popularity in recent years. Thematic investing is based on the idea that certain aspects of the economy will be on the rise at any one time – environmental issues, for example – so companies specialising in that area are likely to do well. Some would say this is simply a variation on the growth theme, but whatever your view, there is no doubt that spotting trends early will always be a good way to pick the stars of tomorrow.

Now let's look at some of the particular strategies adopted by investors.

Top-down investing

Top-down investors start with the big picture, looking at the global economy and the prospects for regions or countries. Then they consider which sectors within the strong economies show the most promise. After this they go on to look at individual companies.

Bottom-up investing

This approach sees investors picking a company on its particular strengths, without considering the wider economic picture.

Most investment portfolios are likely to reflect a combination of both these approaches, as individual share selections are always going to be influenced to some extent by an awareness of what's going on in the wider world.

Target pricing

Selling a share can be a harder decision than buying it. One way to make the decision easier is by setting a target price when you buy the share, at which you will sell it. Bear in mind that it's almost impossible to get out right at the top of the market, so you shouldn't lose sleep trying.

Baron Rothschild once said, when asked about the source of his wealth, 'I sold too soon!'

Buy and hold

For every approach championed by an expert there seems to be an opposite one. Legendary investor Warren Buffett declared: 'Our favourite holding period is forever'. He takes the view that buying shares in sound companies and holding them for the long term will bring him good returns, so he doesn't worry about short-term fluctuations. The market will end up valuing a company correctly eventually.

Obviously this strategy works best when markets are rising (a bull market). But Buffett would echo the old sporting adage that form is temporary, class is permanent; if a company is sound then it will prosper in the long term.

Of course if there is something fundamentally wrong with a company, then you should probably sell.

Contrarian investing

Contrarian investors have the courage to go against the consensus of market opinion. This carries higher levels of risk, especially for private investors, who are unlikely to have the research resources needed to spot out-of-favour companies. But the potential rewards can be equally great.

Bottom fishing

Similar to contrarian investing, this involves looking for companies that have reached rock bottom. Of course it's hard to know whether the floor really has been reached, and whether the share is ever likely to rise again.

Big is beautiful

Investing in well-established, blue chip companies is a useful approach for new investors. Whilst there may not be great potential for dramatic growth, these businesses are more likely to be stable, and to pay out regular, healthy dividends.

Chartists

Chartists look for trends in the past share price of a company, in an attempt to predict what will happen to it in the future. If the underlying movement of the price – setting aside short-term fluctuations – has been upwards, then the share should be held. As soon as the trend starts moving downwards, then it's time to sell.

Some other ideas to consider

Whichever strategy you adopt, there are a couple of additional approaches that are worth thinking about.

Averaging down

If the price of a share you own starts falling, but you remain convinced it has potential, then you buy some more. This lowers the average price you have paid for your stock, so that the price doesn't have to go back up so far for you to make a profit.

Top-slicing

The opposite of averaging down is top-slicing. You sell enough of the stock to cover your purchase costs, and hang on to the rest in the hope it may go up further.

Tracking stop-loss limit

This is one of the free services offered by The Share Centre, and is an alternative to top-slicing. It's a lot less complicated than the name may make it sound. You automatically sell when the price drops back from its peak by a pre-determined amount, ensuring that you always get out relatively close to the top of the market in that share.

When should I sell?

As we've seen, this can be a challenging question. Here are our top 10 tips to help you answer it.

1. Never be worried about taking a profit

No share price can keep going up forever. So don't hang on in the hope that it will. Setting a target level when you buy is one way to keep things in perspective. And remember that a paper profit isn't worth the paper it's written on. It only becomes a real profit at the point when you sell.

Just as your house is only worth what someone is prepared to pay for it, so your shares are only worth what someone is prepared to pay for them. Take your profit and move on. Wasting energy dwelling on what might have been is pointless and bad for your health.

2. Don't jump too soon

Investing is a long-term game. A share price may not move for many months after you've bought it. If the fundamental reasons why you chose it remain in place, then don't panic. But do keep an eye out for any dramatic changes in circumstances.

3. Don't be afraid to cut your losses

Nobody likes taking a hit, because it means we got the initial decision wrong. But better to cut your losses than lose more.

As with deciding when to take a profit, setting your loss level at the time you buy can save a lot of agonising later on. You don't have to sell, but you should take a realistic view. And you can use the remaining capital to invest in something else.

4. Keep up with the news

What happens in the wider world has an effect on share prices. Not always, of course, but keeping abreast of the news will mean you can take an informed view. Bear in mind that the market may well have already factored events into a share price.

Reading the financial pages and logging onto news websites for specific news and views about shares is also sound practice.

5. Shares aren't for life

The pace of change in the world seems to keep getting faster. New technologies come and go, and globalisation leads to increased competition. All of which means you should be wary of becoming emotionally attached to a share. Review the company's prospects regularly to check that it is still fulfilling the reasons you bought it in the first place.

6. Put your money to the best possible use

It may sound obvious, but when you have a set amount to invest you need to be ruthless about ensuring it is working as hard as it can. That doesn't mean switching for the sake of it – especially when you factor in dealing costs, stamp duty and capital gains tax – but if you find a share with better prospects, it can make sense.

7. You can always buy it back

Selling a share isn't necessarily a divorce; it can be a trial separation. If you fall back in love with it later, you can always repurchase it – possibly at a lower price than you sold it for.

8. Watch the Directors

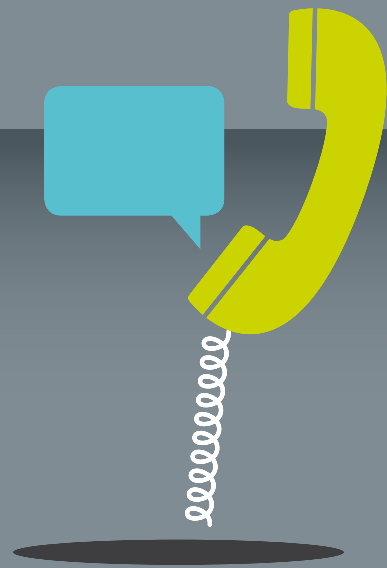
A Director selling shares in a company doesn't necessarily mean something is wrong. They may just be wanting to lock-in some profit, or taking advantage of a time window when they're allowed to sell. But if a number of Directors are selling, it's worth taking a close look at the company's performance figures.

9. Look out for trends

Chartists base all their decisions on past share price data – though past performance is not a reliable guide to future performance. One of the easiest trends to spot is where the share price rises and falls within a certain range – known as a trading range. You could choose to sell when the share gets near its traditional high, and buy it again at the bottom of the range.

10. Separate fact from fiction

Wherever you get your news and views from, be sure to distinguish between what is fact and what is someone's opinion. Of course even the facts are open to interpretation; if they weren't, there'd be a lot more multi-millionaires walking the streets of the City of London!



Become a customer and ask an expert

There's a lot to consider here. Whilst we hope that this guide may have given you some useful pointers, you may well find it useful to talk things through with a professional.

Once you have opened an account with us, our investment advisers are available on the phone, and their services are free of charge. Give them a call and get any questions you have answered.

Please remember

Investing in the stock market is not for everyone. The value of investments and the income from them can fall as well as rise, and you may not get back your original investment. Tax advantages depend on your individual circumstances and the benefits of ISAs could change in the future.

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