Chapter Nine
How to trade in shares

Investors should understand that what is good for the croupier is not good for the customer. A hyperactive stock market is the pickpocket of enterprise.

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The stock market is not in its fundamentals greatly different from the new Covent Garden, Smithfield or Billingsgate markets. Whether you are dealing in turnips, pork or haddock, or the shares of Marks & Spencer, it is just a matter of buyers, sellers, an agreed price, and usually a middleman. And just as the food markets do not encourage people to amble in and ask for half a pound of carrots, so the Stock Exchange is nervous about private investors poking into its electronics and therefore requires an intermediary to feed the investor's instructions into the computer.

In Britain the first recorded joint-stock company (as they were then called) was founded in 1553 to finance an expedition to the Orient via a north-east passage. Two of the ships sheltered from storms in northern Scandinavia and all the officers and crew froze to death. The third managed to reach Archangel and then went overland to Moscow – which was as near to the Orient as they got – where the Tsar, Ivan the Terrible, agreed a trading link. That seemed good enough: the link created business confidence, so others followed the technique for raising money.

With the growing number of joint-stock companies being created, a secondary business arose to trade holdings. As with so many of London's financial institutions (Lloyd's of London, the insurance market and the Baltic Exchange are other examples), it grew out of a coffee house, in this case New Jonathan's. As business grew, the traders moved into a succession of their own premises and in 1773 acquired the name of Stock Exchange.

It has not been an untroubled history. One of the most notorious disasters is the South Sea Bubble. It was not unique either in the shady background or the unhappy consequences.

There used to be 20 other exchanges around the country but they were amalgamated into the one in London. In normal discussion, it is the main market or official list of major companies that is being considered. This is divided up into groupings by trade. There is a section for distribution, one for banks, another for breweries, and there is the technology sector. In addition, there is the Alternative Investment Market, which is for young companies which, by their nature, do not have the trading record demanded for a full listing, or for smaller companies. There is also the Professional Securities Market for specialist securities such as convertibles, debt or depositary receipts. It is aimed at market professionals rather than private investors and the instruments are denominated at least at €50,000. The Specialist Fund Market is also suggested by the name and is for funds aimed at institutional, professional or knowledgeable investors.

How to buy and sell shares

One important difference from the world of meat and veg is that in stock markets one is at several stages removed from the real world. It is not just that the shares represent an interest in a company that may be miles away or even overseas, but increasingly there is not even a scrap of paper to show the ownership of that interest, merely a computer record somewhere. And as the trading becomes more electronic, with trading from one's desktop computer and with the payment being just another electronic instruction to transfer funds, it is increasingly becoming more of a computer game.

Using intermediaries

Just as with other wholesale markets, the small user needs a professional dealer to carry out the investment or sell orders. There is a range of competing firms offering services, and which one you use depends on the type of service needed, though the lines between them are increasingly blurred. Most of them have both telephone and online trading, though for some trades – such as overseas shares – some insist on telephone contact only.

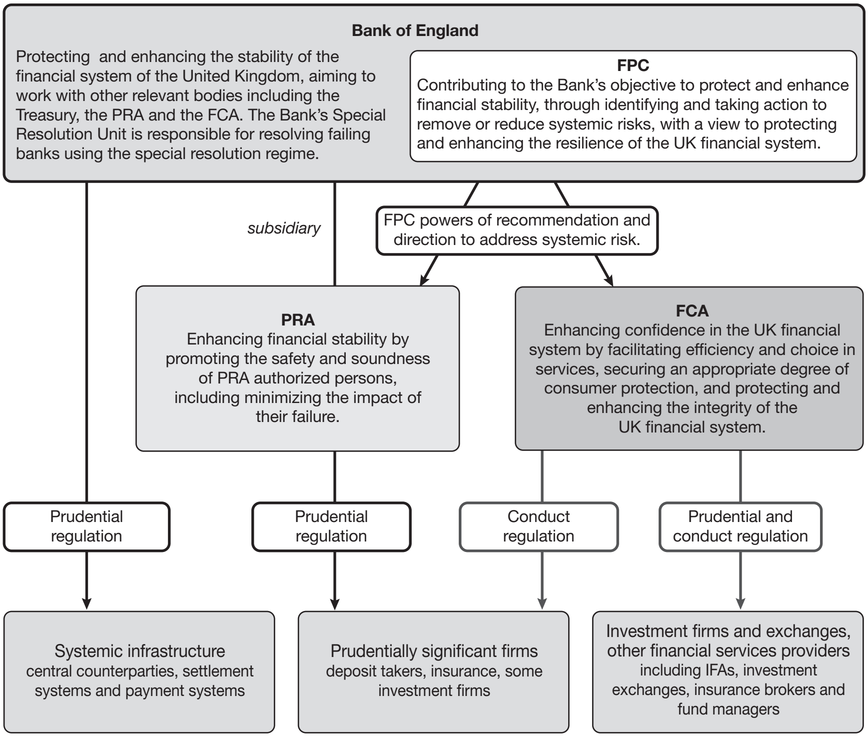
It is always tricky finding the right professional firm, whether architect, dentist, solicitor or doctor, and that applies to investment intermediaries as well. It is not just a matter of financial competence, but also of technical efficiency. There are big, high street financial institutions such as banks and building societies with branches round the country and advertisements all over the place. There are also good local firms experienced in the needs of small investors that can produce performance equal to any of the biggest names in the country. And there are hosts of computer- and telephone-based intermediaries with varying specialisms, costs and services. The best way to pick the company is through recommendation, preferably from satisfied customers, or as a second best from write-ups in newspapers and magazines. Without seeing the people, the buildings, the organization and so on, it is hard to get a feel for how reputable or efficient the broker is, so an investor is driven far more to relying on reputation, recommendation and newspaper opinion.

Make sure that the broker or intermediary used is authorized and hence supervised by the City authorities. Not only does it provide reassurance of some quality monitoring, but provides a way to complain and seek compensation.

Warning

'Phishing' messages and e-mails trying to extract personal information for fraud and identity theft have become common and quite sophisticated – they often look convincingly authentic. But as with the ones purporting to come from banks, e-mails from the Financial Conduct Authority, the Bank of England or the Ombudsman asking for personal information or money are fakes. Sometimes they even create false telephone switchboards. Do not respond and do not access any of the links. Delete them and telephone the FCA on 0800 111 6768 or send an e-mail to consumer.queries@fca.org.uk; the Financial Ombudsman on 0800 0234567; the Bank of England at enquiries@bankofengland.co.uk.

FIGURE 9.1 Roles of the bodies in the regulatory architecture



An uninvited phone call from people you do not know trying to sell shares is likely to be a scam. They are from 'boiler rooms' – bogus stockbrokers, usually based overseas (sometimes with a UK freepost forwarding address). You will almost certainly lose all the money. It is not just novice investors who are duped this way. Most of the victims are experienced investors, with 41 per cent of victims having been investing for over 11 years. The average loss is £20,000 with the biggest individual loss recorded by the City of London Police being £1.2 million. The scams net between £200 million and £500 million in the UK every year. They sometimes promise to recover money lost to the original boiler room, or to purchase those worthless shares (once an up-front fee has been paid). Some offer to buy shares you own, usually at a higher price than their market value, and ask for payment up front, as a form of security, which they say will be returned if the sale does not go through. They sometimes demand signing a form to prevent disclosure of the offer details. Some investors are encouraged to sell previously highly regarded company shares, such as banks and financial institutions and to invest in green or new technology shares, or even to take out loans to fund new investments. These fraudsters are usually well spoken and knowledgeable. They can be very persistent, phoning many times and even sending documents or forms to complete. It is an advance fee scam – they take the money and you never hear from them again. They may claim you have already entered into a contract to buy the shares and are under an obligation to pay. This is not true and such contracts are unenforceable under UK law. Fraudsters occasionally have the gall to threaten investors with police action if they refuse to go ahead with an initially agreed transaction. The police say they 'do not and would not act as a debt collection agency'. If they try that one tell your local police force or City of London Police.

Generally it is against the law to 'cold call' trying to sell investments, so authorized firms do not contact you out of the blue offering to buy or sell shares, but there has been a dramatic increase in the fake use of names, registration numbers and addresses of people authorized by the FCA. They even copy the websites of authorized firms, making subtle changes such as using different phone numbers. Check on the FCA website if a firm is authorized.

There is no recourse, right to complain or to compensation in the UK, as boiler rooms are based overseas and so not authorized by the FCA. If you have not invited the call, just hang up.

See also www.fca.org.uk/scams.

If you have been contacted by an unauthorized overseas firm or suspect a scam, forward the information to the FCA or the police as they are trying to pursue the crooks, even through governments. The initial contact should be actionfraud.police.uk or by phone 0300 123 2040.

Then there is the constant fear that online transactions can be eavesdropped by shady characters who might use your particulars to deal for their own profit, or hack into your or your broker's computer and tamper with data. There is always the danger of computer failures too. Computers seem to have reached about the level of development and reliability of cars in the late 1920s when drivers had to know about magnetos, drive belts and distributors to cope with the continuous breakdowns. That means, just when you need to deal, one of the machines may be having its wick trimmed or its elastic being changed. Also, online trading does not generate share certificates. The shares are still registered to the new owner, but it is all computerized and generally the broker will hold the title to them in a 'nominee' account, which is administratively tidy but could mean the investor cannot easily change allegiance to another broker. An investor can request a paper certificate.

Another danger is the seductive world of computing. Sitting at a home screen with access to all that information, it is easy to be lulled into thinking the data are comprehensive and reliable, and also into making a snap decision. It almost feels like a game using Monopoly money, so one is drawn into making investments at the click of a mouse that could wipe out the family's savings.

To join one of the growing band of online stockbrokers, one needs to get on the website and follow the instructions for registering. Many of them demand a cash account from which payments can be made, with almost all of them requiring a float of cash deposited with the brokerage. There is interest on this, but generally below what it could earn elsewhere. The signing-on procedure asks you to set a password to prevent others looking at, much less tampering with your investments, and explains the minimum level of software capability needed to get into the system.

Technical competence and infrastructure show in the speed and effectiveness of reactions to telephone calls or online contacts. Timing can be crucial in a trade and there have been complaints about the speed of reaction and indeed the ability to get anything done. In 1999 a Jersey-based investor who had his computer screen displaying share prices contacted his telephone broker and saw the value of his holdings halve while the stockbroker left him hanging on listening to a recorded message telling him all customer service operatives were busy and he would be connected as soon as one was free. He was kept on hold until somebody could be found to talk to him. So great were his irritation and frustration at watching the continuing plunge of his investments and his inability to sell that he had a fatal heart attack.

When picking a broker, therefore, it is useful to get recommendations from experience, but a few questions are still in order, such as service quality, terms and conditions, including redress when things do not go according to plan.

Stockbrokers act for individual investors by executing their orders in the market, so the punter telephones the broker who holds the agreed account or more commonly contacts the firm on the internet – and gives the order to buy or sell.

Online intermediaries usually demand investors deposit a float big enough to cover the deal and if it is larger than the immediate purchase they do pay interest on it until the money is actually invested. People are understandably reluctant to get involved in an area rife with unseen dangers. But it is changing rapidly. Customers happy to see a waiter disappear with their credit card for 20 minutes without worrying whether he was nipping up the road for a shopping spree were also prepared to read their card number out to some unknown person at the other end of the telephone for an order. These people are now increasingly buying books, CDs, holiday tickets and the like on the net and relatively few have been ripped off.

From time to time there are tales of pimply schoolboys extracting credit card numbers from online trades, but few people have lost money as a consequence and it is a lot rarer than having your car stolen or your house burgled. The danger of some hacker getting into your computer or dealing at your expense is pretty remote. Viruses are a hazard but can be avoided by having a continuously updated virus checker, which applies to anyone who goes onto the net.

There are millions of online stockbroking accounts in Europe and the number is growing. Many of these people have little loyalty to any broker or market, but will trade where it is safe, cheap and convenient.

The more adventurous, who want to buy a US share, may want to go through a US broker in the United States. It is liable to be cheaper than the British stockbrokers, and cheaper even than the European offshoots of the US brokers. A site that compares the performance of several online brokers on costs, speed of service and other benefits including helping small investors to get a subscription at the time of the first listing, is www.europeaninvestor.com.

One of the big thrills in the United States is day trading. This requires spotting the small fluctuations and getting in and out of shares within one day. For all the fashions and the hype, and despite the many books explaining how to make a fortune from the practice, it looks as if hardly any private investor has made any money on the system. Many lose heavily.

All this can be accessed and organized from anywhere, via telephones and computers, and some brokers are also introducing voice-recognition systems to provide share prices over the telephone. Whether the trading intermediary is a stockbroker or independent financial adviser, there are three basic ways the service is provided – discretionary, advisory or execution-only.

Discretionary

In effect the investor is handing over control to the adviser. It will still mean setting out the overall plan or strategy at the start, as discussed in Chapter 5: the degree of risk, the time horizon, the preference for capital growth or income, and so on. That means a prolonged preliminary discussion setting out those priorities and aims. Once the broker knows what you are trying to achieve with your money, the advice can be more sensible and helpful. After that, however, it is all up to the professional to decide what and when to buy and sell. It had therefore better be someone whose integrity, judgement and effectiveness you trust.

This approach has the advantage of using an experienced market operator with access to more information on a continuous basis than is available to a lay investor. It also has the benefit of swift reaction – the adviser/stockbroker can react immediately to a market movement and not have to wait until the investor has spotted it or gives approval. Needless to say there is a price: one has to pay for expertise.

Discretionary service demands a reasonable minimum amount of initial cash or holdings – the lowest is about £10,000 but £50,000 or £100,000 is more common, and the management fee is about 0.5 to 2 per cent of the size of the portfolio. The investor hands over the portfolio and gives the broker the right to manage as best he or she can, buying and selling as seems right. One gets a regular report of what the investments are and how much they are worth, plus notification of any dealings. Some brokers will also take into this service management of bank accounts, pensions and even insurance.

Independent or restricted advisers do not offer discretionary service. Some broker members of the Wealth Management Association do under stringent UK and EU regulations.

Advisory

Investors who want to retain control over the portfolio but would still like to have the professional's advice can opt for receiving suggestions. This works on the assumption that not every suggestion will lead to a trade, or it might be easier to hand the whole thing over and let the adviser get on with it. At least it allows the novice to learn the way market participants think and the sort of stimulus that prompts action, as well as getting informed opinion. It could be a type of tuition process on the road to taking over total control of one's investments.

Any firm such as a stockbroker offering advice has to meet suitability rules on things such as risk and coverage of the client.

There is obviously a fee for this service as well, though it is lower than for the complete discretionary operation.

Execution-only

Investors with the confidence that they know what they want and how to find it, with enough information and time to watch the markets, can save themselves money by going it alone. All that is needed then is to go on the website or the telephone and give instructions on what is to be done. Some of the brokers/advisers provide free services to help, such as elementary charts and portfolio valuations, as well as some highlights from stockbrokers' circulars.

Transaction-only brokers are available widely, mostly online. Information on low-cost brokers is available through tables published in many of the more serious newspapers and investment magazines.

Trading

Normally when the instruction is given to deal, the broker will transact 'at best' – buy at the lowest available price and sell at the highest. Another option is to set the broker a limit – set the maximum at which you are prepared to buy or a minimum price below which you are not prepared to sell. Usually such limits last for only 24 hours, though some brokers may be prepared to accept longer instructions of this sort.

Once the transaction is complete the broker sends a contract note detailing the deal and how much money is to change hands. It may take a little time to receive the share certificate but that is incidental since it is your presence on the share register that really determines ownership of the holding. The inconveniences can be circumvented by having the broker keep the holdings in a 'nominee' account (see page 139) or by having them registered in Crest, the Stock Exchange's electronic registry of share holdings.

Stock markets

Where stock markets used to have a physical presence where people met and haggled about deals, electronics has liberated them so the disseminated market is everywhere and nowhere. This is presenting the authorities with an increasingly difficult task in monitoring, and presents the investor with a growing challenge to make sure the deal is authentic, the price is right and the securities really are being transferred.

The London market operates a software called Seaq for the smallest company trades. For the majority of dealings the market uses the retail service provider which accounts for 94 per cent of retail trades, the rest going on to Sets (the Stock Exchange Electronic Trading System) used by institutions. This is an order-matching system, so buyers and sellers post their requirements and if possible the computer matches them. Since these screens show not even the broker, much less the investor, only the two sides to the deal know the identity of the ultimate buyer and seller. There is also SETsq for the less liquid (ie less traded) securities.

Companies have been moving to Sets MM, an electronic system that involves market-makers (hence the MM) divulging their bid and offer prices. The Stock Exchange says this cuts spreads and increases the value of shares traded. The completed deal is passed to yet another computer to organize settlement. The Crest system is trying to eliminate the blizzard of paper by replacing share certificates with an electronic record in much the same way that one's hoard of gold and cash has been transformed into an item in a bank's computer memory. For the mistrustful and Luddite investors, share certificates are still available.

Many of the execution-only brokers try to simplify life by putting their investors' holdings into a 'nominee account'. That means the shares are registered to one broker account in the Crest and the companies' share registers, which make the deals quicker and cheaper.

Other markets

In addition to the traditional major stock exchanges, many of which are amalgamating across boundaries, a new breed of smaller exchanges has sprung up, some affiliated to the big ones. Retail users generally get access to some of these markets via their stockbrokers who use them as necessary for a trade.

Alternative Investment Market

Usually known by its initials Aim, this is actually merely a part of the stock market reserved for smaller businesses. The idea is that eventually they mature, grow and graduate onto the main market, so it is sometimes called the 'cadet branch' of the stock market. This means that younger companies with a less-solid or shorter record of profits are allowed to join. But the costs for the business of getting on to Aim are almost as high as for the full listing, so the main attraction is the lower hurdle and access to the market publicity. Another problem is that Aim shares, like smaller quoted companies on the main exchange, go in and out of fashion with institutional investors.

That provides an opportunity for the small investor. Shrewd opportunists who spotted internet stocks as having a good future when they first appeared on the Aim market made a massive amount of money, since some shares rose tenfold in a matter of days. It is no guarantee though, because the self-same shares later plummeted and some of the much-touted businesses collapsed altogether. But then smaller companies are generally more vulnerable to problems. Companies quoted on this 'junior market' can also suffer from exaggerated share price moves as they are often entrepreneurial businesses, in which the founders retain a large chunk of the shares.

Since the market was set up to provide access to young and small companies – important for advanced technology businesses – the aim was for a lighter system of regulation. But this has brought criticism, especially from rival overseas markets, that Aim companies are too lightly regulated and hence less safe.

High growth

To attract medium and large companies with the promise of fast global growth, an easier route to the market has been devised for the ones which may not meet the normal eligibility tests for a full market quote. They must be in the European Economic Area, trading and with a record of good growth.

Euronext

This is the share and derivatives market created from the amalgamation of the exchanges in Amsterdam, Brussels, Lisbon and Paris plus the

London International Financial Futures and Options Exchange. It therefore became the second largest in Europe, behind London. The Atlanta-based Intercontinental Exchange which owns the New York Stock Exchange also bought Euronext, which has itself been floated as a quoted company, but held on to the London International Financial Futures and Options Exchange (abbreviated to LIFFE and pronounced life).

Eurex

The German Deutsche Terminbörse and the Swiss Soffex combined to become Eurex, Continental Europe's largest derivatives exchange.

ISDX

A small London-based stock market which bought another of the smaller stock exchanges, Plus Market.

Turquoise

Seven investment banks with the London Stock Exchange set up a separate market to compete with itself, called Turquoise. But it is mainly for members of the new set-up, such as institutional investors, who can trade in equities, depositary receipts, ETFs (see page 20) and rights issues across 19 European countries.

Tradepoint

A midget rival to the London Stock Exchange, Tradepoint is a completely automated electronic order book market started in 1995, which curiously enough is itself quoted on the Aim part of the main Stock Exchange. The business is 54 per cent owned by a consortium of banks including the US merchant banks Goldman Sachs and Morgan Stanley Dean Witter. It has formed an alliance with the Swiss exchange SWX to create a new exchange called Virt-X, regulated by the London authorities, in which the Swiss have a 38 per cent stake.

In addition to trading in the normal UK quoted stocks (though it has only about 1 per cent of the total trade), it has set up clearance and registry systems to allow trading in Eurotop, the 300 largest companies in Europe.

Nasdaq

Nasdaq is the acronym for the National Association of Securities Dealers Automated Quotation system. It is second only to the New York Stock Exchange (often called the Big Board) as the largest stock market in the United States and is one of the four big ones in the world. As it has kept costs of entry and administrative demands comparatively low, many young companies, especially in technology, have opted to be quoted there, including internet companies like Amazon. Some, like Microsoft, Dell and Intel, stayed there despite their subsequent growth.

It has countered the threat of the internet-based share trading systems by forging alliances with some of them. There is a growing number of such schemes, including ones run by Bloomberg, Reuters and MarketXT. The computer-based systems can post quotes and execute trades on Nasdaq Intermarket, including in shares quoted on the New York Stock Exchange.

The operation has opened a Tokyo market, has a London office and is organizing a pan-European operation, which should make it a global exchange with a permanent and continuous trading system.

Nasdaq OMX Europe

Easdaq has used the principles and the software from Nasdaq to start a Paris-based operation but with markedly less success.

Chi-X

Chi-X started operating in March 2007, backed by Japanese investment bank Nomura. The venture claims to offer a system 10 times quicker and 10 times cheaper than existing trading systems and allows investors to deal in European stocks.

BATS Europe

This was founded out of the United States-based trading system BATS, marking its move into the European equities market. It went live in late 2008 and was bought by the Chicago Board Options Exchange.

NYSE Arca Europe

This is another pan-European trading facility, which is fully integrated into the NYSE Euronext systems. It is regulated by the Dutch regulator Autoriteit Financiële Markten.

Other routes

Electronic trading exchanges may emerge. The internet is continuously providing new opportunities. Two market facilities already running are called Posit and Instinet, which are principally for institutional investors, but others are promised or at trial stages.

There is also talk of disintermediation (cutting out the middleman) by companies raising capital. Raising money by a public issue of shares is a costly business for a company, not least in the enormous fees to accountants, lawyers, stockbrokers and merchant banks. It would be attractive if all this could be bypassed by making the shares available over the net. Small investors for their part seldom get their hands on new issues because they are snapped up before they get there, or more often companies opt for the cheaper route of placing the issue with institutions. It could be dodgy for the smaller investor, however, since there will be less assurance that the professionals have crawled over the business to check its figures, managers and promises, and it is difficult to tell from the puff appearing on the screen whether a company even exists as described, much less whether its managers are competent and honest.