Chapter Five
How to pick a share

> *I started with nothing. I still have most of it.*
>
> **JACKIE MASON, AMERICAN RABBI AND COMEDIAN**

Anything to do with money is a matter of difficult choices. The savings and investment part also demands a line of careful decisions. First comes the grading of safety and access to spare cash. There is the current account for everyday expenses, followed by the amounts accumulating for predictable larger spending such as holidays, redecorating the home, replacing the car, the children's education, and so on. Then comes the provisions for a safe old age, life assurance, pension and rainy-day reserves. Only when these necessities have been taken care of comes the riskier area of stock market investment. It is not cash you will need to realize at short notice but will supplement income for your old age, say.

Stock market investment is for cash you can spare in the sense that if its value falls it may be disappointing and inconvenient but will not cause serious hardship. It is also for people whose nerves can stand uncertainty – for people who will not lie awake at night fretting about the fluctuations of share prices or get ulcers if the business invested in goes off the boil, or even down the pan. If you can think of it in the sense of an alternative to a flutter on the 3.30 at Sandown, or a punt at a roulette wheel, and can accept reverses with a reasonably philosophical shrug, the stock market may be for you.

That is not quite a fair picture, since if the horse you back fails to win, all your stake is gone. Money in shares has a pretty fair chance of not vanishing completely as most companies stay afloat and continue to pay dividends to provide some return on the investment. In any case, unless you were being forced to sell, a drop in share price is only a notional loss while dividends continue to arrive. On top of that, not only are the odds way ahead of other forms of gambling, but the return is better than other forms of investment. Careful research, monitoring and evaluation can reduce risks on the stock market. If the hazards could cause alarm, it does not mean the stock market is closed to you. You can still benefit from the long-term performance of shares by the reduced-risk route of pooled investment vehicles (see Chapter 3). The money is still invested in shares but the dangers of big losses are lessened by spreading the risk.

But that does not end the decision making – on the contrary, it just starts it on a new tack. To sift the right investment from the many thousands available through stock exchanges takes a series of tests and decisions. There are risk/reward calculations and approaches to decide – other people can help by spelling out the options but not take the decisions for you. For instance, some people are prepared to bet at odds of 14.5 million to one against them, which would normally seem insane, but because the cost of taking part in the National Lottery is only £2 and the winnings can run into millions, lots of people are prepared to take a punt.

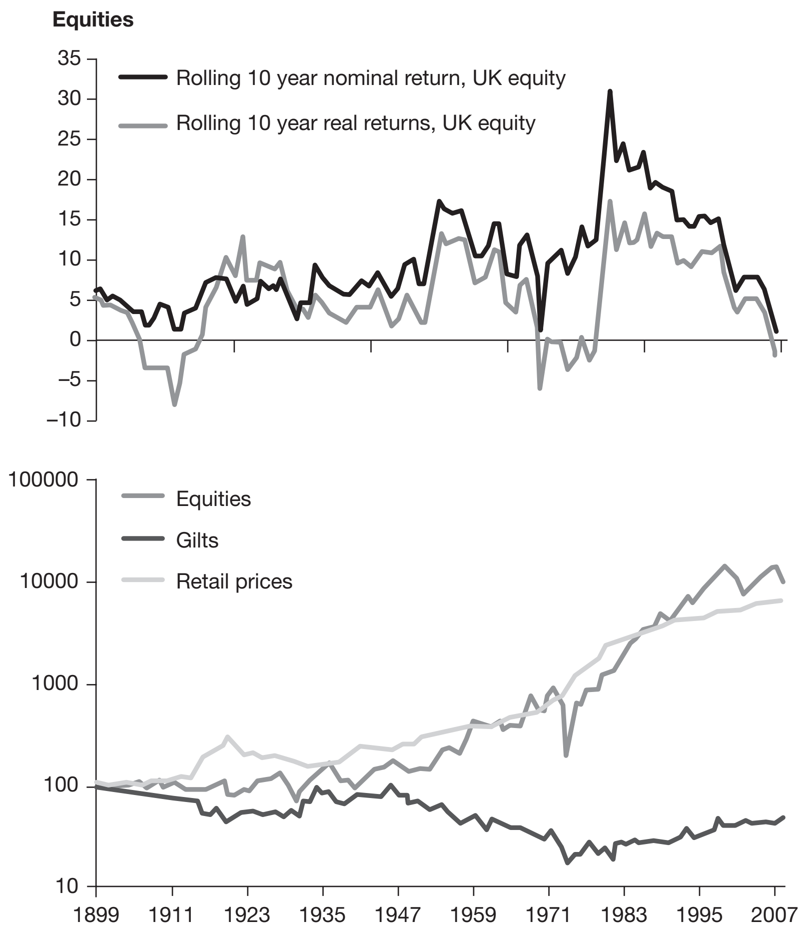
That shows some of the criteria for decisions. One way of screening the thousands of potential investments is to set your own goals clearly and explicitly. It is not nearly enough to say the aim is to make money out of the stock exchange. The process involves:

- Deciding the acceptable amount of risk. Compared with the return on a safe home for the cash like gilt-edged securities or a deposit account at a building society, is the profit from shares enough to compensate for the risks? How much risk am I prepared to accept, first in general, for investing in shares at all, then in the particular sort of shares to go for – such as accepting that small and new companies are more in danger of failing but do have the potential for a larger percentage growth in both share price and dividend; some companies are seasonal or more reactive to economic fluctuations; overseas shares include an element of currency risk?
- Setting a time horizon for the investment. Whether the investment is to be short, medium or long term: volatility of share price can be disregarded for the long-term investment and so the shorter-term investments would be more stable businesses.

- Choosing if it is to generate an income or capital growth. The former would send you to companies with a higher yield (the dividend as a percentage of the cash invested in the shares), the latter for companies with lower dividends but the potential for higher corporate growth.
- A host of subsidiary decisions, possibly including ethical considerations, territorial preferences, etc. Some people might be averse to tobacco, arms manufacturers, contraception, dealing with dictators, alcohol, inadequate ecological performance, poor labour relations and so on.

That process should help narrow the field slightly.

FIGURE 5.1 Long-term stock market prices



Another criterion might be the sort of reward you would need for the admitted risks of investing in shares. Both sides of that equation are subjective – risks vary with the timescale, the choice of investments and the range of holdings; rewards need to be compared with the return from alternative uses of the money such as putting the cash on deposit, into gilts, or into other investments such as property, art and so on. Returns on equities (another term for shares) are usually several percentage points higher than on gilts, which in turn are several points above deposit accounts, but what the real return will be in the future is only an extrapolation – history shows that both absolute and relative values change.

Even that is not the end of it, because there is no reason to insist that the whole investment pot is governed by a single strategy. Or, to put it another way, the effect of even a strong initial strategy can change as the amount and range of the investments grows. The first forays into the stock market might be guided by a low-risk long-term income demand. But as the portfolio extends, people are sometimes prepared to say that, the safe basis having been set, it is fair to try for a higher return by taking on a riskier investment. In addition, as they get more experienced and knowledgeable, some people are tempted to try a little more active trading to benefit from shorter-term fluctuations in particular companies or sectors.

Strategy

Risk

There is no such thing as a risk-free investment. Come to that there is no risk-free life. In investment there is economic cycle risk, company risk, exchange rate risk, income risk, inflation risk, market risk, sector or industry risk, and so on. In this context that usually means capital risk, ie the danger that the share price falls or, worse still, that the company founders. No one share can match all one's preferences, so the policy has to be to balance the spread of shares to match risk needs and then assess each new investment to maintain the balance.

There are risks connected with the quality of the company's management, business area and size. In addition there are vulnerabilities such as great reliance on a managing director (causing major problems if such a key person dies or leaves), or a high portion of business with a few customers (which can be nationalized or go bust). It can also be because the business sector is doing badly through a change in fashion or competing products arriving, or health dangers associated with the product. It can also be because the whole market has fallen flat on its face. The results can be hit by turmoil in the currency markets or interest rates, or the state of the economy. In addition, some shares react more violently to market movements. The degree of this responsiveness is known to professionals by the Greek letter beta, β (see Chapter 6).

Companies with risk factors will probably have higher than average yields. This is called the 'equity risk premium' because it is generally recognized – not just in the stock market – that if you have to carry greater risk you should be rewarded with more money. Higher-risk companies with greater yields are fine for gamblers, or people with a sufficiently diversified portfolio to offset the risk by spreading across other, less dangerous companies and sectors.

Some trades have traditionally been volatile and precarious, and some we can tell from instinct are vulnerable. They may move sharply with fashions, seasons or the economic cycle.

Another good indicator is the way the rest of the world regards the business. There are three useful indications of this: the beta, the price/earnings ratio and the yield, the last two of which are available on the newspaper share prices pages. Beta is a measure of the price volatility, measured against the market as a whole, and is strongly correlated with risk. The P/E is the price of the share divided by the attributable earnings, so a high P/E says the market expects a faster than average growth, and a low one means the general feeling is that the company will languish. In effect the price reflects, or discounts, the expected growth in the dividends the company will pay over the next few years. A very low P/E indicates a lack of market enthusiasm, probably because it considers the business risky.

The yield will show a similar pattern. There is a caveat here, though. Some shares have a low P/E and a high yield not because they are intrinsically dodgy but because they are unfashionable. And this is where the so-called perfect market breaks down and a shrewd investor can get an edge on the professionals. For instance, companies with a small market value were avoided for years for two main reasons: the major investment funds could not fit them into a policy of buying in big chunks of money yet ending up owning only a small percentage of a company; and few analysts bother to look at most of the shares. This neglect meant it was possible for the small investor to find relatively high yields on investments by buying into these companies.

Similarly, if a couple of major companies in a sector – retailing, computers, insurance or whatever – report lower profits, leaner margins and tough times ahead, all the similar companies will be marked down. There is some sense in that, since the chances are that most of them will be affected in a similar way. If one discovers, however, that by good luck, good management, or good products, one company in the disdained sector actually has cash in the bank and is achieving a substantially higher profit margin than most of its competitors (and the figures are reliable and not just window dressing), then it will provide a relatively cheap way in, either for a good income or for capital growth when market sentiment reassesses the whole area of business. In other words, the signals of high risk were misleading or mistaken.

It is a foolhardy investor, however, who relies heavily on this sort of luck or imagines he or she knows better than the market. In general the market is more often right than wrong and the figures really provide a pretty good indication that there is something potentially dodgy. It is sometimes possible to find gold where others see only dross, but do not rely on it.

With investments, as with the rest of life, there are no free rides. Everything has a price. If something has a higher risk, it is likely to offset that with a higher return. What victims always forget when they get caught in something like the Bank of Credit & Commerce International's or Lloyd's of London problems, or a series of frauds like the Nigerian scam or the prime bank paper, is that the corollary of that rule also applies: if there is a higher than expected return there is probably also greater danger. Only very small children and people whose greed overcomes their common sense expect something for nothing in this world.

There is a market in risk. One can hedge against it – take financial measures to limit the extent of risk. Companies hedge their currency exchange exposure on foreign trading by buying currencies forward, and other such devices. An investor can limit losses on a share by buying options.

That in summary is the passive approach, accepting the market's view and making the best of it to suit your personal criteria. Assuming that on a risk continuum of 1 to 10 you are prepared to be cautiously brave by opting for 6 does not mean every share has to be scored as a 6. It can mean a range of really safe 2 with the occasional reckless flutter on something like an 8 or 9.

Each time a buying opportunity comes along, it is worth at least thinking about how it fits into the overall portfolio picture and how far it will move the overall average risk profile. This will have to be done more carefully the longer you hold shares because, as the prices move, the various companies will change their percentage of the portfolio total and their effect on the total risk balance will also alter.

If the long and elaborate process of picking shares seems too hard, or the risk/reward system seems daunting and it all requires more effort than you have to spare, you are not alone. Some of the sharpest investment minds in the United Kingdom and the United States have admitted the chances of being able consistently to pick winners are pretty slim. And in any case, it may be unrewarded effort. The market as a whole, as represented by the FTSE100 Index, does pretty well thank you on any reasonable timescale. Tracker funds that follow the main stock market index can be an answer: the private investor can take a stake in one of those, or be a little more adventurous and go for an investment or unit trust with a broad but selective range of investments.

Defensive stocks

Some companies are reckoned a good bet for volatile or hazardous times. They operate in areas that are relatively immune to economic cycles and include companies dealing in tobacco, as that is a relatively steady market, and supermarkets because people go on buying food. Utility companies also tend to be in demand in bear markets, as people still need, regardless of a recession, water, electricity and gas.

Emerging markets

The label is generally applied to stock exchanges in countries which are becoming industrialized, becoming wealthy and with a growing number of local quoted companies. It is vague enough to encompass the BRIC countries (Brazil, Russia, India and China) which are pretty big and a next generation group which includes Mexico, Indonesia, South Korea and Turkey. Some include eastern Europe such as Poland, Hungary and the Czech Republic. These markets can be volatile, performing spectacularly well or plunging equally spectacularly. Other potential hazards include wayward supervision, lack of accountancy rigour, and less than full transparency.

Long or short term

As all the newspapers, magazines and books say, over the long term the stock market has produced a better return than almost any alternative. On the other hand, as Lord Keynes pointed out, in the long term we are all dead.

Over a period of 30, 50 or 100 years, returns from shares outperformed most other investments. They do better than property, antiques, deposit accounts, fine wines, building society savings, and so on. Since 1918 shares in Britain have on average provided a return of 12.2 per cent a year, compared with, for example, 6.1 per cent produced by the gilt-edged securities issued by governments. Those figures are despite the US market falling 87 per cent between September 1929 and July 1932, the UK index dropping 55 per cent in 1974, the steep drop following the hurricane in October 1987, or the plunge from 2007, and the Far East market battering in the 1990s.

Cash in a deposit account would have produced even less than government bonds, probably something under 5.5 per cent. Taking a more recent period, from the end of the Second World War, equities have on the whole (taking into account both income from dividends and capital appreciation) beaten the inflation rate by about 7 per cent or more.

So on average – which is always the important word of warning to bear in mind – shares provide a good long-term home for spare cash. The return on shares is almost always higher than gilts, and certainly so over the long term. This is to compensate for the greater risk: index-linked gilts are guaranteed, while companies are subject to the vagaries of economic circumstances. The resulting difference – the greater return on equities – is therefore called the 'equity-risk premium'. On the assumption you will not have to sell the shares to raise cash at any particular moment, you can afford to take the long view over which shares perform best. Because even normally sensible people forget the dangers, the government has insisted on the apparently obvious wealth warning on all the literature and advertising that the price of shares can go down as well as up.

Another aspect of the decision is whether you want income or capital growth. These are not complete alternatives since any company doing so well that it hands out great dollops of cash in dividends is almost certain to see its share price bound ahead. But not always: even a cursory glance down the prices page of a newspaper will show huge disparities in the yield figures. But if you are aiming for capital appreciation, the shares will be sold to crystallize the profit, while income shares will be retained until they stop producing an adequate flow of cash.

Experienced investors, experts and people prepared to devote time and serious effort deal. It entails bouncing in and out to take advantage of the short-term oscillations of the market. You spot a takeover trend, say among food companies, and get in as the other companies start rising; or you detect a growing fashion for a technology – computers, internet, biotech, etc – and pile in as the boom starts to sweep the shares to unrealistic heights. But this also means you have to watch the market like a hawk and see the sell signals in time to get out with a profit. Such tactics demand more spare money. The proportionately higher costs of spreads, broker's fees and government tax mean you have to deal in larger amounts and achieve bigger share rises to make a profit (see Chapter 8).

One other point – every time one person manages to make a big profit, somebody else misses it. They may not always make a loss but just fail to get the real benefit. What makes you think you will be the winner every time, or spot the real successes and avoid the duffers? Some people do have a talent but not many.

At the more extreme end is the recent upsurge in 'day-trading' (buying and selling within 24 hours), which can be achieved fairly readily over the internet. The figures from the United States, where the fashion started, suggest that fewer than 5 per cent of the people doing it make money.

Ethical investing

The growing insistence on responsible and moral behaviour by companies both towards people and the Earth, means companies with sound ethical policies are more likely to prosper. So such a policy is good not just for the conscience but the wallet.

Personal choice dictates where to draw the line. Companies shunned by some investors have included tobacco, armaments, makers of baby milk for Africa, oil, paper and timber (deforestation), mining, pharmaceuticals (animal testing), alcohol, and so on, to say nothing of specific companies being boycotted because of their policies on pollution, ozone depletion, waste management, personnel, etc. But it can produce confusion if pursued too far. Being opposed to gambling would presumably rule out the National Lottery, which could preclude all the shops and supermarkets that sell tickets. And how about buying gilts from a government that encourages arms manufacturers, trains soldiers and probably funds research centres that carry out animal experiments?

The ultimate point is that the investor should be able to sleep at night, not just because the money is safe, but because there is no need to worry one is supporting a company that oppresses workers or helps to kill people. On the other hand, it is then only logical that one not only avoids making a profit from the company's success but also stops buying its products.

A useful source of information on this is the Ethical Investment Research Service. It was set up in 1983 by several Quaker and Methodist charities and researches over 1,000 companies plus most collective funds, and keeps a list of fund managers and stockbrokers concentrating on ethical investments. Another is Cantrade Investments.

The economy

Deciding on a share or even a market sector – such as retailers, property developers, engineering manufacturers or financial companies – involves a second level of investigation. It means looking at the economy as a whole and then the way it affects the constituent parts.

Forecasting the economy can be a mug's game. Governments are substantially worse at forecasting than the Met Office. Harold Macmillan complained when he was prime minister that national figures were so out of date it was like driving a car looking only in the rear-view mirror. It has got little better since. Most big companies do some forecasting, the major financial institutions such as banks have substantial economic departments focusing on that, and there are any number of specialist economic or econometric organizations. The projections seldom agree and if any of them is right it is more by luck than by judgement. Fortunately however, the individual investor does not need to get into the sort of complex detail those institutions attempt, and common sense tempered by personal observation will usually help.

Factors that can affect investment tactics include:

- the rate of inflation – both the Retail Prices Index (RPI) and the Consumer Prices Index (CPI);
- the general health of economy – whether it is rising, falling or on the turn;

- the exchange value of the pound – against the euro, dollar, yen or trade-weighted;
- industry trends – eg growth in retail spending, house-building and prices, engineering concerns suffering from exchange rate movements.

On most of these one can get a pretty good feel from reading the newspapers and keeping an eye on what is going on at the local high street estate agents, for example. One can get it wrong, but then so can the pundits holding forth from parliament or on television. And the stock market itself will give a pretty good indication of what the rest of the investment world thinks: if it is falling people expect trouble, if a sector is shunned there is a reason (and it is worth investigating if only to see whether you agree), if share prices are rising optimism abounds (and even then it is worth checking whether you think such euphoria is justified).

Picking shares

Once you have set the ground rules, you need investments to fit them. Warning: almost everyone who has ever had anything to do with the stock market has a theory of how to pick a share. They are similar to addicted gamblers and their sure-fire systems for winning at roulette or horse racing. The bookshops are bulging with pet schemes and private formulae. Those winning methods come in predictable categories. There are the strategic views, which range from in-and-out trading all the time, to the opposite extreme of buy and forget. There is the tactical advice category that shows the infallible way to pick the best bet. It does not take long to demonstrate the fallacy – if there were a certain and predictable scheme for making money everybody would have been using it long since.

That is not a recipe for despair. Although borrowed tactics will not produce infallible opulence, there are some common sense ways of looking at companies and their shares that will increase the chances of success. This is serious stuff however, and an investor who hopes to make money out of the stock market will have to make an effort. Everything has a price, and the cost of making money is usually hard graft. The famously successful Warren Buffett did not get rich by accident or by following a secret trick; he thinks, eats, breathes and sleeps the stock market. He may not be the world's wittiest and most wide-ranging conversationalist, but then you have to ask yourself just how seriously you want to be rich, or even slightly better off.

It cannot be said too often: beware of all advice. Do not reject it out of hand, but just remember nobody gets it right all the time (see Chapter 7). And even the people who do get it right more often than not, seldom know how they do it – their explanations are usually post-hoc rationalization as they struggle to explain just what instinct drove them to buy that or sell the other at just the right time. If by some mischance they really could formulate the trick, they would be very foolish to share the secret with the rest of us and so queer the pitch for themselves.

Judging by the proliferation of such books there is clearly more money to be made from publishing accounts of a wonderful new way of making a fortune on the stock market than from putting the principle to work and buying shares. Why otherwise would all those people be so diligently occupied writing and getting people to compete with them in searching for the routes to fortune, when they could be researching the market and dealing?

The point for an investor is to absorb all information available, but to weigh it carefully and always to test it against common sense. Following someone else's method slavishly will probably not work, but some combination of the methods described in this section should help most people evolve their own way of approaching a challenging but personal task. Here are a few examples to show the diversity of methods and advice available.

One set of investment guidelines has six rules:

1. In funds or sectors go for the ones near the bottom of the league tables. The top performers are usually overpriced or are last year's fashion.
2. Go for shares with high yields, but if they survive that long, sell in a year.
3. Watch what directors do with their shares.
4. Buy companies where at least 3 per cent of the shares are owned by the workforce.
5. Companies spending over 4 per cent of turnover on research tend to do well.
6. Buy after a profit warning if the company is fundamentally sound but going through an unlucky patch.

Even Warren Buffett claims to have a formula (if you can call it that, so wonderfully simple is it), but it is not very obviously helpful to the novice investor. When pressed, his advice was to buy good businesses and hang on to them. Which is about as helpful as the advice for success in business: buy cheap and sell dear. The businessman Richard Koch elaborated: buy companies with a good trading record, specialize, watch profit trends, stick to companies with good business reputations, pick companies that generate lots of cash and produce a high return on capital, risk part of the portfolio on emerging markets, and sell any share that has dropped by at least 8 per cent. T Rowe Price, who launched a fund in the 1950s, advised concentrating on companies with long-term earnings growth records and the chances of continuing that way, which he defined as reaching a new peak at the top of each business cycle. These are in an industry where unit sales and profits are rising, and have good patents, products and management. The US investor Michael O'Higgins reckons you should select the 10 highest-yielding shares in the index, and then pick the five with the lowest share price.

Malcolm Stacey, the author of an investment guide, advises spreading the money among sectors, buying slow but steady risers, and sticking to leaders (including ones in their sector). He also has a system of setting a price differential at which dealing is triggered – if the filter were set at 10 per cent then every time the share fell 10 per cent off a peak one should sell and start buying again when it came 10 per cent off the bottom.

Many of these people advocating systems have themselves been successful, but note how varied the advice is. So beware of formulae, but be especially wary of fashionable investment gurus.

In clear opposition to all those wonderful systems is the view that any attempt to outperform the average is doomed to failure – it is just not possible. The 'random walk' theory says movements of prices are inherently unpredictable in both size and direction, and as a result any wins or losses are purely a matter of chance. In the long run you will end up even, or at least will have moved with the market as whole.

Another hypothesis that also asserts that trying to outperform the market is a waste of time says the market is efficient in the economists' sense – it incorporates in the share price all the available knowledge. That means everybody has access to all the information about the company, economic prospects and the market, and there are no people with enough financial clout to move the market. As a result, the price of shares already reflects the concerted and probably relatively accurate view of the totality of investors, private and institutional. Since shares have no 'correct' price, runs this hypothesis, and are worth only what somebody is prepared to pay for them, the general consensus view is the right price.

Nice theory, but even the most cursory glance will show the stock market to be anything but random and a long way from being rational. There are anomalies, and not everyone has reacted yet to the information that can be gleaned. Information may be available but not everybody has taken it on board.

In addition, the market does not act in line with the economists' depiction of optimizing behaviour. The swings seem to demonstrate frequent overreaction, amounting at times to hysteria or blind herd stampedes, and it is clear some people do have a shrewder appreciation of what is going on than others. If it were an efficient market, making it therefore impossible consistently to do better than the average, how do you explain people who have actually made themselves – and sometimes their clients – a major fortune? There are some notable names who have steadily made money and some famous investment managers who have over a long term performed about five to six times better than the market as a whole.

A plain indication that the perfect market is some way off can be gleaned from even the most cursory look at the views of stockbrokers' analysts on company shares – there is little general agreement about the prospective performance of many companies. The price cannot have incorporated all these views because they contradict each other. And as the old saying goes, two views make a market.

The academics are therefore modifying their views and conceding there may be pockets of inefficiency continuing to exist that could provide the sharp analyst with an opportunity. Market practitioners have also pointed out that this sort of rigid academic picture depends on the timescale – in the very short term, movements in prices may seem random and irrational but the longer you extend the period the more logical it becomes.

Fundamental analysis

In deciding what share to buy and when, the first thing to remember is that there is no absolute or correct price. This is a market, so the value is what people are prepared to pay. But that is at any one time. A realistic view is that the stock exchange is quite plainly a very long way from the economists' perfect market with perfect information. But it is a reasonably efficient market so the shrewd analyst can spot companies or sectors that are out of favour or have a greater potential than the market seems to recognize, can anticipate price movements when the new information spreads, and so make an above-average profit. The tacit assumption contradicts the random walk theory as well as trust in the combined wisdom of all traders, and asserts it is possible to calculate the value of a business, and that the share price will eventually tend towards the true value.

This is the province of fundamental analysis. This is the process that:

- evaluates a business and its products;
- examines its published accounts, including return on capital;
- takes a guess at earnings, earnings potential and dividend prospects;
- looks at the economic ambience, such as the rate of inflation, the level of sterling, consumer demand and interest levels;
- watches the market the company is selling in and what its competitors are up to; and
- judges the company's management.

A diligent investor can try to keep an eye on advertisements for high-powered jobs in case they show a company about to move into or enlarging an important new area (such as the internet), which could be an insight not available to many. All of that research produces a way of deciding whether the business is fairly valued by the market.

But never forget the price is set by market reaction, so it is pointless to say a company's shares are undervalued. If the market continues to undervalue the business, the shares will become no higher.

The assumption behind doing this work is that the market has developed only a temporary blindness or misjudgement and will in due course come to appreciate true value. So one is aiming to pick winners not yet spotted by others. Assuming the analyst is right and way ahead of the rest of the market, a correction could still take years, during which time the company could be so seriously hampered by its low share price that its business is overtaken by competitors.

There are two additional factors to take into account before acting on such analysis. One is the basis for the current share price and the other is market feel.

Share prices are based more on the future than on the past. That means a price may be lower than the available figures suggest would be just, because the market expects the next set of results to be poor – and of course vice versa. That is often based on a combination of what was in the last corporate announcement and what influential stockbrokers' analysts have been projecting for the figures and have been saying about the state of the company. That is the reason, incidentally, why shares sometimes act paradoxically: falling on the publication of good trading figures or rising after a mediocre result. The market has already factored those numbers into the share price, and after publication is reassessing the shares in the light of the next set of results. If you think the market has got its expectations wrong it is possible to trade in the hope of a sharp reaction when the true figures come out, if they are in line with your projections. This requires that you are not only right, but that the rest of the market views the new information in the way you have expected.

For instance, a company may be producing pretty comfortable levels of profit and yet its shares fail to respond appropriately. There may be many reasons for that. The company may be too small for the major institutional investors, which dominate the market. Or it might be because the market reckons that further down the road there is trouble looming, or because the price had already reflected just that level of profit, or even because the company may be good but the sector is currently out of favour.

This is where market feel comes in – the result of all that reading of the financial press, listening to the radio, etc, and just good instincts. This is not about being more accurate than others in the market, but being able to anticipate the ways others will see and use new information. Some people just feel there will be an imminent shift in attitudes to a specific company, an industrial sector, or a type of company, but the more you know and the harder you work the luckier you will be.

One way to make such decisions easier is to set them down at the time of purchase. You work out how much the share is undervalued – what would be its right market capitalization, price/earnings ratio, yield, or whatever, considering its sector, performance and prospects? When it passes that level on the way up you watch like a hawk for signs the market realizes it has again overreacted, this time in the upwards direction, and then you must sell at least part of the holding. Never be afraid of missing the boat – it could just be the *Titanic*, as it was for the South Sea bubble in the 18th century, the railway mania in the 1830s, and the dotcom lunacy in 1999, among others.

In 1998–99 any business that had a new web-based idea or which produced software for internet trading, or invested in such enterprises, suddenly became the philosopher's stone. Share prices doubled every six weeks, with one going from 230p to £87 in less than a year; companies unknown a few months earlier were suddenly worth hundreds of millions. It was heady stuff and many people got carried away. The boom was clearly unsustainable and triggered an equally exaggerated reaction. It took over a year for more sensible approaches to prevail; the internet is evidently a big business opportunity but will not produce limitless profits overnight. The sensible investors spotted the opportunities early and the very sensible ones realized when the optimism had been overdone, and either sold or at least hugely reduced their holdings.

Bear in mind also that you are not alone in this quest. There are droves of analysts being paid ludicrous amounts of money to help institutions beat the market, plus millions of private investors on the hunt for the end of the same rainbow. As a result, the prices in the main reflect the sum of their expectations both about the company and the market in which it operates. In other words, they set the price not on what it is doing now but what it is likely to be doing over the next couple of years – the price has discounted the future.

Nearly all these calculations are done from published accounts (see Chapter 7). They are filed at Companies House, but most companies will send a copy to prospective investors if asked nicely. Extracting information from the mass of data is a painstaking business requiring application and experience. There is nothing difficult about it, but one has to learn the language of accounting, have an inkling about some of the dodges companies use, and understand the significance of the numbers. The accounts reveal not just what the formulae calculate, but a wealth of other information. Elaborate financial engineering, suggestions of skilful burnishing of results, or careful reallocation of figures are all signs that the business is not all it seems or that the management is a touch flaky. Either way, these are characteristics to avoid.

All this research can yield data of such volumes it buries information. For the private investor the answer is to create a set of personal filters. This can be by sticking to companies with a P/E ratio of no more than five or six, or with a yield at least 10 per cent above the average. It can be by looking at neglected sectors; for example, is it fair that retailing should be under such a cloud; is manufacturing still going through those troubles that made professional investors shun them; are breweries really a better bet than catering companies? In a sense it is being the counter-cyclical investor.

Some people even consider shareholder perks. These are the benefits many companies provide as added inducements: restaurant chains and house builders, clothing retailers and insurance companies, palm-top computer makers to ferry operators, give discounts to shareholders. Those should be a bonus and not a reason for buying.

One then selects from that long list the companies that may appeal for other reasons. The best approach is to combine all of that with the other criteria available, such as a look at the country's economy (some types of company do better on an upturn and some survive downturns better), the shopper's view (see below) and technical analysis (see Chapter 6).

Tracking

All this discussion assumes an investor is trying to do better than the market as a whole. It is not the only strategy. Many individuals and hordes of investment funds reckon the task is too fraught and opt for the safer course of just trying to keep the investments as good as the market as a whole. Since on a longer term the market trend is generally upwards, this is a safe and lower-risk approach.

Shell and recovery stocks

Potentially spectacular changes of fortune could come from shell and recovery companies. They require a specialized form of forecasting. 'Shell' companies have little or no existing business but are clinging to a continued stock market listing. Their purpose is to act as a cheap way for another company to get a stock market quotation. Some sharp managers can move in, raise money to acquire other companies (possibly private), or another business can get onto the exchange by a 'reverse takeover' – the quoted company is legally buying the unquoted but is in reality taken over by the unquoted one's managers and business. By definition it is almost impossible to get much information about such outfits or their prospects.

A 'recovery' stock is of a company that has suffered a poor period and is on the mend, or has acquired a doctor to heal its ills. It could bring rapid returns, but history shows the odds are against you. As Warren

Buffett said, 'When a company with a reputation for incompetence meets a new management with a reputation for competence, it is the reputation of the company that is likely to remain intact.'

That is a sobering thought from an acknowledged winner, but it is not always true. Stumbling companies have been rescued from the edge of the abyss by company doctors or revised policies. In addition, though the stock market may show its dislike, the profits could be down for some very good reason: the company has invested a massive amount into research and development for a series of new products that will create huge new markets; it has bought a new business that will extend its own range; it has restructured the company to be more efficient (including expensive redundancies); and so on. It is always worth looking behind facts for causes. There may be the seeds of hope, or Buffett could be right and the loser will sink into oblivion.

The converse does not hold true, as recent years have demonstrated all too clearly. Winners do not hold their top place for ever. J Sainsbury and Marks & Spencer were for a long time revered as the retailers with the magic touch, and it seemed they could do no wrong – until they seemed in the eyes of the market to do everything wrong and their shares tumbled. IBM was at one stage prophesied to eliminate all other computer makers.

By the same token the soar-away success of yesterday seldom lasts till tomorrow. Before getting too misty eyed at the success of a share that has doubled in price in the past three months, just stop and extrapolate – if it goes on like that will the company be able to buy the whole of France and Germany in five years' time? Actually, even without being silly, it is worth considering whether it is reasonable for the business to be comparable with long-established companies such as Unilever or Shell. That creates a sense of perspective and may prompt one to cream off profits and distribute the proceeds to other likely successes.

Bearing all those factors in mind, one can then begin to set the criteria for an investment policy that relies less on hunch and hope and a little more on a realistic appraisal of personal needs and market circumstances.

The shopper's view

Consumers know from personal experience that there are some goods, some shops, and some service companies that really seem good value and helpful, and they keep buying. Other customers may well feel the same way, in which case it could be a good business. And of course the opposite is equally a warning – if you have stopped buying some goods or going to a chain of shops because the goods are shoddy or the value is poor, sooner or later others are likely to spot that as well.

For instance, if shopping at Sainsbury has become expensive and a pain and you are going to Tesco instead, or vice versa, a similar view may strike other shoppers, and eventually the profits and share price will reflect that. Similarly, if you have come across a product or service that seems outstanding as well as providing good value, and the company behind it seems sound and ambitious, it may in due course become a darling of the stock market.

In a wider context, one can spot when a market has abandoned reality and is stoked up on hope and greed. Examples were the dotcom bubble, and the property boom in the 10 years to 2007 when many sane people could see that Gadarene swine were rushing headlong they knew not why, and could sense that things would end in disaster. The shrewd ones listened to instinct, watched sales and prices, listened to early reports of concern and exited with profits. But they were rare, and judging from the disastrous effect on financial institutions, they did not employ many of them.

Losers

There is one outstanding characteristic shown by professionals that seems curiously absent in the amateur investor: the ability to drop losers. Small-time investors appear to have a sentimental attachment to shares they have bought no matter how bombed out the company, or perhaps they just hate to admit making a mistake, which taking a loss would entail. The share price falls from 850p to 55p and they sit and wait for it to creep up again, though any dispassionate view will show it to be heading to something between 20p and hell.

Some investors even go in for 'averaging down' – buying more shares at the lower price to bring down the average cost of the stake. This is on the assumption that the shares are about to recover. But to do this successfully you really do have to be absolutely copper-bottomed certain you are right and the market will soon share your view.

It would probably be more sensible to see if there are better opportunities elsewhere in the market, and shed the loser. One way the big boys keep their policy in check and make such decisions easier and more automatic is by establishing an action point – the stop-loss signal is triggered by a fall of 10 to 15 per cent.

Perks

In addition to the usual benefits of owning shares, such as capital appreciation and dividend income, many companies try to keep shareholders loyal and enthusiastic by providing perks – most of them are merely discounts and therefore entail additional spending by shareholders, which helps profits. For some there is a minimum holding before the perks kick in. Some stockbrokers provide lists.