Chapter Eight
What does it take to deal in shares?

Most advisers reckon £2,000 is the smallest sensible amount for a single investment, though many recommend £3,000. It is possible to deal in smaller amounts at one time but it puts up an extra barrier to making a return: stockbrokers set a minimum price on transactions and the dealing costs can overwhelm the profit from the transaction. If you are dealing in a small company's shares that have a wide price spread (the difference between the buying and selling price) the threshold for potential profit is raised still further. And there is also a government tax on dealing (see page 102).

For example, if the dealing cost is £20 for a £500 parcel, the share has to rise by more than 8 per cent just to break even, bearing in mind the likely dealing spread. That means a share standing at 220p would have to rise by over 18p before the investor saw any benefit. It can happen, but it is just stacking the odds against yourself. However, competition among stockbrokers is increasing with the numbers of sites on the internet growing daily, so the cost could start coming down and with it the minimum economic investment.

Mark Twain said there was nothing wrong with putting all your eggs in one basket, but *watch that basket*. That is unlikely to work for the stock market. Scrutinize a company with all the attention possible, analyse its figures and read all the reports available and, despite all the favourable indications, it can still decline, to general surprise. Sudden external changes can overwhelm sound businesses, and inept managers can so fail to keep track of what is happening under their noses that nobody outside notices either until profit warnings show the depth of the problems, or takeover predators or the liquidator move in.

For safety, therefore, one needs to spread the risks over a number of companies. A decent portfolio even for a relatively small investor would contain at least 10 companies. That is the eventual safe haven however, and it does not mean everyone must start with at least £20,000 going spare for it to be worth even thinking about the stock market – it just means these are the sensible requirements to reduce the much-publicized risks. Remember, the main aim of investing is to get a decent return for an acceptable risk. With one share the risk is greater, but the more companies' shares you own the less chance there is of your entire stock market holding suddenly collapsing to nothing. It is possible to build a range of shares over the years; indeed most advisers reckon it is a good idea to keep a little float of available cash to take advantage of opportunities.

A really rich investor can put money into property, fine art, venture capital, currency funds, etc, and spread equity investment all round the sectors and the world. That way all risks are hedged. For most of us, offsetting one or two of the dangers is the best we can hope for. The two most obvious risks are that the money will be eroded by inflation, and that all of it will disappear through corporate incompetence.

It is a general rule that the lower the risk, the lower the return – which generates its own obvious warning that if somebody is offering mouth-watering returns or even a profit that seems markedly above comparable destinations for your cash, you may rely on it: there is a catch. The converse also holds true: the higher the risk, the higher the potential reward. Invest in a single share and if you struck it lucky the investment can multiply many times in a single year, and for some people with an appetite for danger that offsets the risk that the company could fold, taking every penny of the investor's money with it. In general this is to dramatize what really happens – in practice it is far more common for the share you own neither to burst through the roof nor crash through the cellar but to pootle along in the doldrums for months or even years, producing little movement in the price.

That £20,000 may look a formidable sum – especially if one thinks about it as the minimum safe level of holding – but set it against lifetime earnings of well over £2 million for even a relatively lowly paid household and it begins to seem a little more doable. On the other hand, if the total costs listed here and the amount needed to provide a reasonably safe income seem out of reach, there are less daunting alternatives, though still with a link to the benefits of the stock exchange, such as investment or unit trusts (see Chapter 3).

Investment clubs

An alternative to managed, pooled vehicles looked after by a professional is an investment club. This is a group of private investors who pool their cash and jointly decide how it should be invested. This has the advantage of spreading holdings over a larger number of investments than any single member could manage, without having to pay the fees of a unit or investment trust or other professional management company. You forfeit the expertise of the unit and investment trust people but have the fun of picking your own shares (or any sort of investment) and get a social occasion thrown in as a bonus. The attractions are becoming more well known: in 1997 there were about 350 clubs, but the London Stock Exchange estimates there were 5,000 by 2009.

The ideal number of members for a club is somewhere between three and 20. With more than 20 members the club will be called a corporation by the Revenue and you will have to start paying Corporation Tax.

The specialist charity ProShare publishes a handbook with some useful advice on how to go about starting a club; most experts recommend members read other guidance as well to get a broad range of expertise. It is not vital any member really knows about the intricacies of the stock market, but it is handy to have a range of knowledge among members about, say, engineering, brewing, retailing and so on.

It is vital to get the organization set up on a formal basis or there could be some very painful surprises and arguments later. There are model rules and constitutions available, which everyone has to sign. These set out, among other things, how people may join and leave, a unit valuation system and how decisions are made. A wide range of other issues need to be agreed: the level of monthly subscriptions; when and where the members meet; how decisions are made; appointing a chair, treasurer, and secretary; and deciding on bankers, stockbrokers and accountants. You have also to decide whether the club will continue to accumulate a portfolio or whether it is to have a finite life of, say, five years, after which the proceeds are shared out among the members. Some have specified that there be no recriminations if an investment goes wrong. Also, some formal mechanism has to be set up for the holdings. They can be held by one member on behalf of the rest (usually the treasurer), or by a nominee company set up for the purpose, or even by a bank. Several stockbrokers have packages for investment clubs.

You might be invited to join an existing club, in which case it is wise to check that all these decisions have already been made and are in accord with the sort of thing that feels comfortable. Also check that the monthly contribution is in line with what you can afford or would want to put in.

If this route sounds fun, there are still some basic considerations to prevent tears later. First, only get together with people you like and trust, and whose objectives and preferences are similar to your own. If you fancy taking a punt on the latest high-technology start-up or going for risky recovery stocks, it would be a mistake to join a club whose members reckon buying into Vodafone is pretty racy.

The criteria for choosing investments vary widely among the clubs but many opt for the riskier end of the market because the club participation is additional to the investments members have already made on their own behalf. So, they are generally fairly ready to go for Aim, technology stocks and the like. Some even extend beyond the stock market and invest in property, directly or indirectly. The main advice of the experts is not to invest in anything you do not understand and most professionals strongly suggest avoiding the complex and risky end of the market, like derivatives.

Second, it is not a free ride where you can relax on the coat-tails of more expert and hardworking members. Most clubs share out the work and make it clear they expect people to participate beyond just putting in the monthly money, even fining them if they turn up late for meetings.

Most clubs invest well under £100 a month – a common figure is about £20 to £40 – so this is not the prerogative of the wealthy. Conversely, it is unlikely the proceeds will allow anyone to retire at 30 or buy a Caribbean island. But you never know – the Hampshire village of Whiteparish has a club that managed a 49 per cent return on its investments (and won the prize for being the best), and even some children's clubs have managed returns pretty close to that. Several have built portfolios worth £500,000. Only a few have done so badly that members have lost their cash.

Costs

As with so many other things, it is more expensive in Britain to trade in shares than in many other industrialized countries. International comparisons have shown cheaper dealing overseas and fewer complaints about speed and information. Some US brokers also allow small investors a chance to get in on the ground floor by participating in a flotation – what they call there an 'initial public offering', or IPO.

Not that the US brokers themselves are universally regarded as kindly philanthropists. There is an old classic book about Wall Street, reprinted regularly over the past 40 years, which comments on the wealth of brokers – it is called *Where Are the Customers' Yachts?* Competition and technology may be changing all that.

For all the loud proclamations by the Stock Exchange, small individual holders are still considered a nuisance. Small investors deal in small amounts, which cost just as much to transact as large deals, and the shareholders need elaborate protection from sharks and their own folly because they might sue or generate snide stories in the newspapers, and MPs are likely to kick up a self-interested fuss. However, the market needs the small investor as a counterweight to the unimaginative short-termism of the major institutional holders. Private investors generally also provide a market for smaller companies that are not practical investments for major finance houses.

Brokers' commission

The main cost of dealing comes from the broker's commission. It varies depending on the type of broker, the amount of work being done, and the size of the deal.

Some charge as little as £5 minimum for dealing, but most brokers charge around £12 to £15 minimum per transaction, though there are brokers going as high as £20 to £25, with a commission on a sliding scale above the minimum, depending on the value of the transaction. An order of £2,500 might cost 1.5 per cent, with the rate falling to 0.75 per cent or sometimes even lower on major deals. There may also be a one-off charge of at least £10 for joining Crest, the Stock Exchange's electronic registry of share holdings.

A site on the internet called www.fool.co.uk provides a guide to charges of net and telephone brokers. It is not comprehensive and sometimes misses a new service or special offers from some of the participants. It is not unusual for a new entrant to buy a bit of market share by enticing in the passing investor through having an introductory period free of charges. Other online comparison sites suggest other options but all further information needs examination.

The spread

There is also the cost of trading. As anyone who has ever tried to sell a second-hand car knows, the price of something is very different depending on whether you are buying or selling. So it is with shares, which is fair enough because the trader needs to eat as well. To make sure the dealer does not starve, this 'spread' varies with the risk. So FTSE100 companies like Vodafone, Barclays Bank, Unilever, etc, which have huge market capitalizations, thousands of shareholders and a regular flock of deals every day, would have a relatively narrow spread of under 1 per cent, and some may drop as low as 0.03 per cent; by contrast a tiny company with few shareholders and little trade could have a spread of around 10 per cent.

This makes small companies and their shareholders unhappy because it creates a vicious circle. It is much harder to make a profit from small-company shares because the price has to rise far more to offset the wide spread. That deters all but the hardiest optimists, which therefore means fewer trades in the shares, so reinforcing the wide spread.

Advice and portfolio management

If you use a financial adviser to help pick investments, there is obviously a charge for the research and for the expertise in sifting the results to provide the advice.

Some people get a real buzz from organizing their investments. The combination of gambler's hunch, rational analysis, the prospect of profit, a chance to outsmart the highly paid professionals, and the arcane language of finance combine to produce a fascinating pursuit for some people. That is lovely because it creates the best sort of hobby – the sort that makes money.

Without that confidence, enthusiasm and time, one can still look after the investments but on a more intermittent basis. These are the people who read the City pages of the newspapers and keep up to date with the economic trends; they revalue their investments reasonably regularly and then decide what the best course might be.

As with advice, another option is to subcontract that work and get professional help, not just with building but also with managing a portfolio. Though some independent financial advisers and asset management companies will take on portfolios from £25,000 upwards, many of the companies are reluctant to look at you with less than £50,000 to play with. The fee structure means it would probably not be worth it if they did – and many managers prefer more than £100,000. This can be done through a formal scheme. That brings advice and comment from the stockbroker but still leaves the final decision on buying and selling and the amounts to be put in to the investor.

Another alternative is 'discretionary' management, which passes on the preferences and criteria (see Chapters 5 and 6 on how to sort those out) to the broker/manager, who then takes on the job of picking both the stocks and the timing. All this costs money of course – either a flat fee of, say, £1,000 a year, or a percentage of the portfolio managed, which can be 0.5 to 1 per cent depending on size. It goes without saying that you only give this sort of power over your personal finances to someone you trust, but even then keep an eye on them: some stockbrokers have been disciplined for 'churning' – continuously buying and selling to generate commission for themselves.

It is up to the individual to decide whether the advice, information and management are worth the cost. For most novices it may well be, but as they get more experienced, learn how to ferret out financial data, and get used to the way it is presented in newspapers and magazines, many decide to strike out alone. Either way, if a financial adviser is looking after strategy or portfolio management, do check from time to time whether the investment performance has been better than average, as that could easily have been achieved by investing in a tracker fund or exchange traded fund. Even if it is better, a second calculation should show that the performance was sufficiently better to more than offset the management fees.

Tax

After the market-makers, stockbrokers and advisers have taken their fees, the government takes its additional cut from our savings through a tax called stamp duty reserve tax at the rate of 0.5 per cent on the value of every purchase in UK equities of over £1,000 (for UK companies, foreign companies with a British share register, rights and options), even though it was made using income that had already been taxed. For more on taxation, see Chapter 12.

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.

WARREN BUFFETT

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