Chapter One
What and why are shares?

Businesses need money to get started, and even more to expand and grow. When setting up, entrepreneurs raise some of this from savings, friends and families, and the rest from banks and venture capitalists. Backers get a receipt for their money which shows that their investment makes them part-owners of the company and so have a share of the business (hence the name). Unlike banks, which provide short-term finance at specified rates that has to be repaid, these investors are not lenders: they are the owners. If there are 100,000 shares issued by the company, someone having 10,000 of them owns a tenth of the business.

That means the managing director and the rest of the board are the shareholders' employees just as much as the shop-floor foreman or the cleaner. Being a shareholder carries all sorts of privileges, including the right to appoint the board and the auditors (see Chapter 11). In return for risking their money, shareholders of successful companies receive dividends. The amount varies with what the company can afford to pay out, which in turn depends on profits.

At some stage the business may need more than those original sources can provide. In addition, there comes a time when some of the original investors want to withdraw their backing, especially if it can be at a profit. The only way to do that would be by selling the shares, which meant finding an interested buyer, which in itself would be far from easy, and then haggling about the price, which would be awkward. A public marketplace was devised for trading them – a stock exchange. Companies 'go public' when they get their shares quoted on the stock exchange to make things easy for investors – a neat little device invented by the Dutch right at the start of the 17th century.

Quoted shares

Once a company gets its shares quoted on the stock exchange there is a continuously updated and generally known market price, which is usually far higher than the level at which the original investors put their money into the fledgling business. In addition, there is a 'liquid' market, meaning there are large numbers of potential or actual traders in the paper, and so holders of the shares have a far greater chance of finding buyers, and people who want to put money into the business have ready access.

Blue chips

All investment carries a risk. Banks can run into trouble and companies can go bust. It has an element of gambling and, as you would expect, the odds vary with what one invests in. The major difference is that the only way to win at true gambling is to own the casino or to be a bookmaker, while in the world of the stock market the chances of a total loss are relatively small and with careful investment the prospects are pretty good.

'It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges', wrote John Maynard Keynes in 1935. He himself made a small fortune on the exchange but it is salutary to be reminded of the analogy from time to time and the comparable risks; the term 'blue chip' is an example. The highest value gambling chips in poker were traditionally blue, and the stocks with the highest prestige were reckoned similar. So the companies described as being blue chip are the largest, safest businesses on the stock market.

The companies in the FTSE100 Index, being the hundred biggest companies in the country by stock market valuation, are by definition all blue chips. That is reckoned to make them the safest bets around. The theory is not unreasonable – large companies are more stable than small ones; they can hire the best managers and fund the biggest research budgets; they have the financial muscle to fight off competition; their very size attracts customers; and the large issued share capital generally speaking provides a liquid equity market with many small investors and so maintains a steadier price. In practice some smaller companies, even in the Alternative Investment Market, sometimes can also provide the comfort of a liquid market as a result of brisk trading in the shares.

The corollary to that is the share price movements should be less violent, giving stability (but providing fewer chances of short-term profits through hopping in and out), and the yield is likely to be lower than on riskier investments. Blue chip shares are, in the traditional phrase, the investment for widows and orphans.

But not invariably: blue chips are safer than a company set up last year by a couple of undergraduates with a brilliant idea, but they are never completely safe. They may be about the most solid there is but they still need to be watched. As an illustration, it is instructive to look back at the Index of the largest companies of, say, the past 30 years and see how few remain. Remember that companies like British Leyland, Rolls-Royce and Polly Peck were all in the Index at one time, and all went bust – though with government help Rolls-Royce did re-emerge as a successful, quoted aero-engine manufacturer. Huge banks were humbled across the world in 2008 as a result of their feckless lending, and even companies that do not completely collapse can fall out of favour, have incompetent managers, and shrink to relative insignificance (such as the British company General Electric, which shrank and then became the private company Telent).

The reason not everyone seeks the safety of blue chip shares is their price – so well known that they are pretty fairly valued, and so the chances of beating the market are vanishingly slim. Being generally multinational, they are also exposed to currency fluctuations.

The next set of companies just below them in market value, the FTSE250, is generally more representative of the British economy, which is closer to home and hence more easily understandable.

Finally, small and new entrepreneurial companies may be more risky but that means they have the potential for faster growth and greater returns – provided of course they do not go bust. It is also worth remembering that even companies like Microsoft, Tesco, Toyota and Siemens were tiny once.

So, not all small companies are dangerous just as not all big ones are safe. This is true even of the multinational darlings that were reckoned deep blue. Just consider the fate of the major American airlines, insurance companies or car makers.

That is why tracker funds have been set up. They buy most of the shares in the index they are tracking and so follow its totality. Trackers reduce the chances of a disaster, mitigate the chances of great capital growth, and should ensure a steady dividend flow.

Returns

Shareholders benefit twice over when a business is doing well: they get dividends as their part of the company's profits, and the value of the shares goes up so that when they sell they get capital appreciation as well. The return on shares over the long term has been substantially better than inflation or the growth in pay and notably better than most other homes for savings. According to data from Credit Suisse, Global Financial Data and Thomson Datastream, the return on US shares between 1904 and 2004 was very nearly 10 per cent per annum, and 8.5 per cent on UK shares.

If the company fails to make a profit shareholders usually get nothing, though some companies try to keep them happy and loyal by dipping into reserves to pay a dividend even at a time of loss. In any case, if the company goes bust they are at the back of the queue for getting paid. On the other hand, one of the reasons a business is incorporated (rather than being a partnership, say) is that the owners, the shareholders, cannot lose more money than they used to buy the shares. That is in sharp contrast to a partnership, where each partner has unlimited personal liability – they are liable for the debts of the business right down to their last cuff-links or to their last earrings. So even if an incorporated company goes spectacularly broke owing millions of pounds, the creditors cannot come knocking on the shareholders' door.

Stock markets

The language of investment sometimes seems designed to confuse the novice. For instance, shares are traded on the stock exchange, not the share exchange. Nobody really knows why it came to be called the 'stock exchange'. One theory has it that it was on the site of a meat and fish market in the City and the blocks on which those traders cut are called stocks. An alternative theory has it that stocks of the pillory kind used to stand on the site. In the Middle Ages the receipt for tax paid was a tally stick with appropriate notches. It was split in half, with the taxpayer getting the stock and the Exchequer getting the foil or counter-stock. Some have suggested the money from investors was used to buy stocks for the business.

Strictly speaking, in the purists' definition, stocks are really bonds – paper issued with a fixed rate of interest, as opposed to the dividends on shares, which vary with the fortunes of the business. However, in loose conversation 'stocks' is sometimes used as a synonym for 'shares'. Just to confuse things further, Americans call ordinary shares 'common stock'.

Chapter Two
What are bonds and gilts?

The ingenuity of City financiers has produced a wide variety of paper issued by businesses, in addition to ordinary shares.

Bonds

Shareholders are owners of a company by virtue of putting up the cash to run it, but a good business balances the sources of finance with the way it is used, and some of it can come from borrowing. A part of the borrowing may be a bank loan or overdraft, but to pay for major investments most managers reckon it is wiser to borrow long term. For some of this the company issues a different type of paper – in effect a corporate IOU. The generic name for this sort of corporate issue is 'bonds'. They are tradable, long-term debt issues with an undertaking to pay regular interest (normally at a rate fixed at the time of issue) and generally with a specified redemption date when the issuer will buy the paper back. Some have extra security by being backed by some corporate asset, and some are straight unsecured borrowings. Holders of these must receive interest payments whether the company is making a profit or not. The specified dividend rate on bonds is sometimes called the 'coupon', from the days when they came with a long sheet of dated slips that had to be returned to the company to receive the payment.

Here as elsewhere in the book you will come across words such as 'generally', 'usually', 'often' and 'normally'. This is not a cover for ignorance or lack of research but merely an acceptance of the City's ingenuity. Variants of ancient practices are constantly being invented, and novel and clever financial instruments created to meet individual needs. What is described is the norm, but investors should be prepared for occasional eccentricities or variants.