Chapter 1

Exploring the Basics

In This Chapter

- Knowing the essentials
- Doing your own research
- Recognising winners
- Exploring investment strategies

Investing in shares became all the rage during the late 1990s. Everyone from postmen to pop stars got in on the act. Investors watched their share portfolios and investment funds skyrocket as the stock market reached the mania stage at the tail-end of an 18-year upswing (or *bull market*). (See Chapter 15 for more information on bull markets.) Investment activity in the United States is a great example of the popularity that stocks experienced during that period. By 1999, over half of United States households became participants in the stock market. Millions in the United Kingdom also joined the new gold rush. And millions of them lost money when the stock market fell like a stone (the *bear market* – see Chapter 15 for more on these) between 2000 and 2002. People invested. But they really didn't know exactly what they were investing in. If they'd had a rudimentary understanding of what shares really are, perhaps they could have avoided some expensive mistakes. The purpose of this book is not only to tell you about the basics of investing in shares but also to let you in on some solid strategies that can help you profit from the stock market. Before you invest your first fiver, you need to understand the basics of investing in shares.

Understanding the Basics

The basics are so basic that few people are doing them. Perhaps the most basic (and therefore most important) thing to grasp is the risk you face whenever you do anything (like putting your hard-earned money in an investment like shares). When you lose track of the basics, you lose track of why you invested to begin with. Find out more about risk (and the different kinds of risk) in Chapter 4.

In an old stand-up routine, the comic was asked ‘How is your wife?’ He responded ‘Compared to what?’ You need to apply the same attitude to stocks.

When you are asked ‘how are your shares?’, you may be able to say that they’re doing well – especially when compared to an acceptable ‘yardstick’ such as an index (such as the FTSE 100). Find out more about indices in Chapter 5.

The bottom line is that the first thing you do when investing in shares is not send your money straight into a stockbroker’s account or go to a Website to click ‘buy shares’. The first thing you do is find out as much as you can about what shares are and how you can use them to boost your wealth.

Getting Prepared before You Get Started

Gathering information is critical to your plans for investing in shares. You need to gather information on the shares you are planning to buy twice: before you invest . . . and after. You obviously should become more informed before you invest your first fiver. But you also need to stay informed about what’s happening to the company whose shares you are buying, about the industry or sector that company is in and about the economy in general. To find the best information sources, check out Chapter 6.

When you are ready to invest, you need an account with a stockbroker. How do you know which broker to use and whether to go online or use paper certificates? Chapter 7 provides some answers and resources to help you choose a broker.

Knowing How to Pick Winners

Once you get past the basics, you can get to the ‘meat’ of picking shares. Successful share picking is not mysterious, but it does take some time, effort, and analysis. This may sound like a lot of work but it’s worth it, because shares are a convenient and important part of most investors’ portfolios. Read the following section and be sure to ‘leap frog’ to the relevant chapters to get the inside scoop on ‘hot shares’.

Recognising the value of shares

Imagine that you like eggs and you're willing to buy them at the supermarket. In this example, the eggs are like companies, and the prices represent the prices that you would pay for the companies' shares. The supermarket is the stock market. What if two brands of eggs are similar, but one costs £1 while the other costs £1.50? Which would you choose? Odds are that you would look at both brands, judge their quality, and, if they were indeed similar, take the cheaper eggs. The eggs at £1.50 are overpriced. The same principle applies to shares. What if you compare two companies that are similar in every respect but have different share prices? All things being equal, the cheaper price has greater value for the investor. But the egg example has another side.

What if the quality of the two brands of eggs is significantly different but their prices are the same? If one brand of eggs is old, of poor quality, and priced at £1 and the other brand is fresher, of superior quality, and also priced at £1, which would you buy? Of course, you'd take the good brand because they're better eggs. Perhaps the lesser eggs are an acceptable purchase at 50 pence, but they're definitely overpriced at £1. The same example works with shares. A badly run company isn't a good choice if you can buy a better company in the marketplace at the same – or a better – price.

Comparing the value of eggs may seem overly simplistic, but doing so does cut to the heart of investing in shares. Eggs and egg prices can be as varied as companies and share prices. As an investor, you must make it your job to find the best value for your investment cash. (Otherwise you get egg on your face. We bet you saw that one coming.)

Understanding how market capitalisation affects share values

You can determine the value of a company (and thus the value of its shares) in many ways. The most basic way to measure this value is to look at a company's market value, also known as market capitalisation (or market cap). *Market capitalisation* is simply the value you get when you multiply all the number of outstanding shares of a particular company by the price of a single share.

Calculating the market cap is easy. It's the number of shares outstanding multiplied by the current share price. If the company has 1 million shares outstanding and its share price is £10, the market cap is £10 million.

Small cap, mid cap, and large cap aren't references to headgear; they're references to how large the company is as measured by its market value. Here are the five basic categories of market capitalisation:

- **Fledglings** shares are sometimes known as *tiddlers*. They are small and risky.
- **Small caps:** These shares may fare better than the fledglings and still have plenty of growth potential. The key word is 'potential'.
- **Mid caps:** For many investors, this category offers a good compromise between small caps and blue chips. They offer much of the safety of the big companies while retaining a part of the growth potential of small caps.
- **Blue chips:** These are the established heavy hitters and are ideal for conservative stock investors who want steady appreciation with greater safety. These companies tend to be represented in the FTSE 100 Index. We explain more about indices in Chapter 5.

REMEMBER

From a safety point of view, the company's size and market value do matter. All things being equal, large cap companies are considered safer than small cap companies. However, small caps shares have greater potential for growth. Compare these companies to trees: Which tree is stronger – a sturdy oak tree or a newly planted sapling? In a great storm, the oak has a chance of survival, while the young tree has a rough time. But you also have to ask yourself which tree has more opportunity for growth. The oak may not have much growth left, but the sapling has plenty of growth to look forward to.

For investment beginners, comparing market cap to trees isn't so far-fetched. You want your money to grow without becoming dead wood.

Although market capitalisation is important to consider, don't invest (or not invest) just based on market capitalisation only. It's just one measure of value. As a serious investor, you need to look at numerous factors that can help you determine whether any given share is a good investment. Keep reading – this book is full of information to help you decide.

Sharpening your investment skills

Investors who analyse the company can better judge the value of the shares and profit from buying and selling them. Your greatest asset in investing is knowledge (and a little common sense). To succeed in the world of share investment, keep in mind the following key success factors:

- **Analyse yourself.** What do you want to accomplish through your investment in shares? What are your investment goals? Chapter 2 can help you figure this out.
- **Know where to get information.** The decisions you make about your money and the shares to invest in require quality information. If you want help with information sources, turn to Chapter 3.
- **Understand why you want to invest in shares.** Are you seeking appreciation (capital gains) or income (dividends)? Look at Chapters 8 and 9 for information on these topics.
- **Do your research.** Look at the company whose shares you're considering, to see whether it's a profitable company worthy of your investment cash. Chapters 10 and 11 help you scrutinise the company.
- **Choosing a winning share also means that you choose a winning industry.** You frequently see share prices of mediocre companies in 'hot' industries rise higher and faster than solid companies in floundering industries. Therefore, choosing the industry is important. Find out more about analysing industries in Chapter 12.
- **Understand how the world affects your shares.** Shares succeed or fail in large part due to the environment in which they operate. Economics and politics make up that world, so you should know something about them. Chapter 14 covers these topics, but also take a look at Chapter 2.
- **Understand and identify megatrends.** Doing so makes it easier for you to make money. This edition spends more time and provides more resources helping you see the opportunities in emerging sectors and even avoid the problem areas (see Chapter 13 for details).
- **Use investing strategies like the experts do.** In other words, how you go about investing can be just as important as what you invest in. Chapter 16 highlights techniques for investing to help you make more money from your shares.
- **Keep more of the money you earn.** After all your great work in picking the right shares and making big money, you should know about keeping more of the fruits of your investing. We cover the taxation of share investment in Chapter 20.
- **Sometimes, what people tell you to do with shares is not as revealing as what people are actually doing.** This is why we like to look at company insiders before we buy or sell that particular share. To find out more about insider buying and selling– not to be confused with 'insider dealing' which is illegal – read Chapter 19.

Stock market schizophrenia

Have you ever noticed a share going up even though the company is reporting terrible results? How about seeing a share nosedive despite the fact that the company is doing well? What's going on? Well, judging the direction of a share in a short-term period – over the next few days or weeks – is almost impossible.

Yes, in the short term, investing in shares is irrational. The price of a share and the value of its company seem disconnected and almost schizophrenic. The key phrase to remember is 'short term'. A share's price and the company's value become more logical over an extended period of time. The longer a share is in the public view, the more rational the performance of the share's price. In other words, a good company continues to draw attention to itself; so, more people want its shares, and the share price rises to better match the value of the company. Conversely, a bad company doesn't hold up to continued scrutiny over time. As more and more people see that the company isn't doing well, the share price declines. In the long run, a company's share price and its value eventually tell the same story.

Actually, every chapter in the book offers you valuable guidance on an essential aspect of the fantastic world of shares. The knowledge you pick up and apply from these pages has been tested over nearly a century of share picking. The investment experience of the past – the good, the bad, and some of the ugly – is here for your benefit. Use this information to make a lot of money (and make me proud!). And don't forget to check out the Appendices!

Boning Up on Strategies and Tactics

Successful investing isn't just what you invest in, it's also the way you invest. We are big on strategies such as trailing stop losses. You can find out more in Chapter 17.

Buying shares doesn't always mean that you must visit a stockbroker or that it has to be hundreds of shares. You can buy shares for pennies and use programmes such as dividend reinvestment plans. Chapter 18 tells you more.

Getting Good Tips

Protecting yourself from the risk of losing money (known as *downside exposure*) is what separates investors from gamblers, and Chapter 21 gives you ten warning signs of a share's decline. We know that when we see some of the signs that (at the least) we need to put on a stop loss order (Chapter 17) so that we can sleep at night. Sometimes the return *on* your money is not as good as the return *of* your money.

If shares give off ‘negative signals’, then it follows that they give off ‘positive’ ones as well. Chapter 22 gives you ten of the best signs that are commonly seen before a share is ready to rise. What better time to jump in?

You should be aware about the risks of fraud. It’s tough enough to make money from shares in an honest market. Yet we must always be aware of those that would take our hard-earned money from us without our consent. That’s why we include Chapter 23 – because there’s always a chance of encountering problems when you are dealing with humanity.

Chapter 24 is (I believe) one of the best chapters in the book. You really need to understand if the environment for a particular share is good or bad. The best shares in the world sink in a tough market while the worst shares can go up in a jubilant and rising market. Ideally, you avoid those shares that are in the tough market and find good shares in a good market. This chapter points you in the direction of those markets.