Chapter 1

Introducing the Financial Pages

In This Chapter

- Getting started
- Getting to grips with the major players
- Avoiding transatlantic misunderstandings

Strictly speaking, the term 'financial pages' is a bit outdated. Now that we've got the Internet and television business news and all the rest of it, the chances are that not very many people depend solely on what they read in the papers any more. So much detail comes at you from every side, and so many analysts and economists are pushing their own versions of events at you, that the task of understanding this thing I'm calling the financial pages has got quite a lot more challenging.

No longer do you have to make do with whatever little bits of information you can get from magazines and newspapers. Nowadays, the challenge is to know how to sift through all this stuff, sort out the biased dross, and then act on the sources that you've come to trust and respect. That's bound to seem like a tall order at first. But relax; this process isn't as terrible as it sounds. I'm here to guide you through the basics.

Getting into the Swim of It

If this is your first foray into the strange and maybe frightening world of investing, take heart. Although you can dip in and out, I've structured this book so if you wish you can start at the shallow end of the pool where the water isn't too crowded and the waves aren't too big. Then, once you've got your 10-metre certificate and you're feeling confident enough to get around without your armbands, I introduce you to some of the more ambitious swimmers and the exotic creatures who inhabit the slightly deeper waters. (Only a few of them bite. I make sure you know what they look like and how they behave.)

Throughout the book I introduce you to the lifeguards and referees who are responsible for seeing fair play in the financial markets – and who can order offenders right out of the pool if they don't behave themselves. I show you how to stay in these regulators' good books, and how to read their reports. They're on your side, after all.

The early chapters deal mostly with the stock market. Later chapters describe other ways in which people use the pool, by investing in cash, bonds, and commodities. Not to mention derivatives such as futures, options, and warrants! Yes, we've reached the diving boards, where nobody wears water wings any more, and where you can show off your impressive abilities to the utmost. Providing, of course, that you're happy with the additional risks that you're also taking. Because the lifeguards won't always be able to rescue you if you do get into trouble.

Mention of futures, options, and warrants will probably strike fear into your heart at first. After all, not so long ago bonds cost £100,000 a shot and commodities – raw materials like oil, gold or copper – were strictly for fast-talking experts wearing loud blazers. But these days a small private investor can easily play the commodities game with just as much chance of success as the experts. In Chapter 14 I introduce you to the wonderful new world of exchange-traded funds (ETFs), which work like shares but actually track the prices of oil and copper and gold. They're even tax efficient! You don't pay stamp duty on ETFs. And you can put them in your Individual Savings Account (ISA) if you like.

What do we mean by bonds, incidentally? Well, I don't want to go too deeply into that subject right now – that can wait until Chapter 6 – but let's just say that they're a kind of interest-bearing investment that many people find preferable to shares when they don't want to expose themselves to too much direct risk from the stock market. The general idea is that you're effectively lending money to a borrower – either a government body or a large company – who promises to pay you a (usually) fixed rate of interest for a fixed number of years, plus your money back when that time is over. And what's more, on top of that reliable cash return you've also got the possibility of making a capital gain, depending on how a range of other factors stack up over a period of time.

That sounds really great, doesn't it? But there's the proviso that, if things go badly or if you overpay for your bonds, you could lose some of your capital instead. So it's not quite as simple as it sounds. Even so, a few bonds ought to be in everybody's portfolio because they provide a useful counterbalance to the ups and downs of the stock market.

Slackening off the pace a bit, Chapter 14 takes you through the slightly less unfamiliar world of managed funds, where somebody else does all the work and the only decisions you really need to make are when you buy and when you sell. You've almost certainly got some managed funds already: a few unit trusts, the occasional tracker ISA, and maybe a guaranteed equity bond from your local building society. Furthermore, the chances are that your pension's invested in unit trusts and investment trusts.

Just for interest, I show you how people invest in other countries, and how you can optimise your investments if you're willing to have a little flutter on a few foreign markets instead of only the United Kingdom.

I introduce you to my favourite places for getting hold of the best information. Some of it come from the print media, and a lot of it's from the Internet. These days you can't get away from the web.

I also introduce you, very briefly, to the wild and wacky world of Internet discussion forums and blogs. Now, I'm going to warn you in advance that some of these places aren't suitable for raw beginners, because they can be a little, ahem, robust. If you've ever seen a game of water polo you have some idea of how the discussion board posters sometimes treat each other, and you may decide you want to watch from the poolside for a while before you dive in and get involved. Yes, blogs and discussion forums can get a little brutal – and remember, they're largely unregulated, so you shouldn't always believe everything you read! But then again, you do have the satisfaction of knowing that you're watching world-class sportspeople doing what they do best.

This is the adults' pool, no doubt about it, and it can get rowdy. But I'm not doing my job if I don't at least introduce you to it, because, as I hope to prove, Internet forums can contain masses of good stuff.

Right at the end of the book is a glossary of financial market terminology. I've tried to cover all the basic stuff that's in this book, but you're bound to run into phrases that make you wonder whether you've missed something. You haven't. Instead, I missed it out. But then, I'm writing a book for beginners, not for experts, so the more I can cut the jargon the happier we all are.

Looking at the Key Players

Back in the grand old days of the 1980s, when stockbrokers still wore bowler hats instead of cycle helmets and Bluetooth headsets, and when share dealing started some time after morning tea and biscuits had ended, nobody had the slightest doubt about who did what, because it was all very neatly ordered.

Yesterday's genteel society

The investors were the people who telephoned their orders to their stockbrokers, telling them what shares they wanted to buy or sell, or asking for advice. The brokers then telephoned the *market makers* – the people who kept 'buffers' of shares that they bought or sold to the brokers' clients. Assuming the market makers had the stocks on their shelves, they made them available to the brokers, who bought them on behalf of their clients.

The brokers got the paperwork done, and within two or three weeks (often longer) the investors received their share certificates in the post. The transaction typically cost the investor somewhere in the region of £30, which is closer to £80 in today's money. But then, in those days there was no such thing as today's execution-only trading, whereby you simply tell your broker what to do and don't ask for advice. Instead, every customer needed detailed and personal advice about what to buy. Because the stock market was such a complex and confusing place. Wasn't it?

So everybody had his own job to do, and the division of labour was absolute. Everybody would have been horrified at the idea of a broker doubling as a market maker, because that would have put somebody out of a job. And it was illegal anyway. There was also no question of a bank, still less an investment bank, owning a stockbroker, because surely that created a conflict of interest. So that was illegal too. In America a law even existed called the Glass-Steagall Act, which prevented lending banks from getting involved with the securities industry altogether.

And the broker's analyst was the lowest of the low. He spent his days cooped up in the darkest room in the building with an ancient desk, poring over company accounts and trying to think up new ways of making them sound interesting to his bosses, the stockbrokers, and their clients. If anybody told him one day he'd be the superstar and his stockbroker bosses would be the drones who enacted share purchases that came down a wire into their computers, he'd have laughed in their faces.

Today's drones and superheroes

Today, the investor is still the person who spends the money, but these days he calls all the shots. He generally doesn't need the broker's advice about what to buy, because he can get all the information he needs from the Internet and the financial media; consequently he's more interested in getting his trades done for £8 a time, which is around a tenth of the 1986 cost in real terms. The customer expects to get the important parts of his paperwork done in a few seconds. Indeed, if he's running a *nominee account* (where an intermediary holds the shares on his behalf) he probably doesn't care about getting a share certificate at all. You can go your whole investing career without ever seeing one.

The broker is no longer king of the hill. He does what he's told, and he has to compete hard with his rivals on a cost basis. The fact he doesn't have to pay a market maker any more is good, because he can make markets in his own right if he wants to. (This abolition of the old division of labour was one of the key changes of the 'Big Bang' financial markets deregulation in 1986.) In America the Glass-Steagall Act was repealed in 1999, which was a good thing because the financial markets had widely ignored it for years by that stage.

These days, absolutely no reason exists why a bank shouldn't own a stockbroking firm – and indeed, most of them do. Very few fully independent brokers are still left, and there are no independent market makers at all in London Instead, the whole market-making job is done by brokers and/or the banks that own them.

The same goes for consultancies, accountancy firms, and all sorts of other 'multi-agency' financial firms, which may typically be running broking divisions alongside their lending divisions, their research divisions, and their fund-management divisions. Every single one of these multi-agency outfits is doing practically everything. And the furious heat of progress has melted away every distinction that used to exist between these various roles.

Well, almost. One risk had to be controlled by new legislation. Now that a bank can be advising its own clients what to buy while simultaneously investing its own money in shares to make its funds grow, a potential conflict of interest arises between what its divisions do. Imagine what would happen if an investment bank issued a broker's recommendation instructing its customers to buy a particular company's shares, while simultaneously dumping that company's shares from its own investment portfolios. Wouldn't you be just a little suspicious that it was driving up prices in order to reduce its own losses?

So would I. These days, multi-agency financial outfits are required to maintain so-called *Chinese walls* between their divisions so that their employees can't talk to one another in ways that may be anti-competitive, or that may manipulate the market in any way. Usually the Chinese walls work well. When they don't, the scandal keeps the papers busy for months and can mean a prison term for the company's directors.

And the humble stockbroker's analyst? He's a superhero. Even the ones who don't head their departments get their suits from Armani so they look smooth when they talk to the television cameras. Newspapers hold the front page whenever they speak. The role reversal is complete.

Investigating investors

Investors have never had it so good. That's the theory, at least. They've got more information, cheaper dealing costs, and access to a share purchase at the press of a computer keyboard. They've got tax-efficient Individual Savings Accounts (ISAs) that put their money into a tax-free shell where it can grow and grow without ever incurring any capital gains tax.

Investors can buy shares listed on pretty well any stock market in the developed world, and put those into their ISAs too. When they can't find a share they like, or when they don't feel capable of running a foreign-share portfolio, they can buy an investment trust that spreads their money over a wide range of suitable shares and still charges them zero in management costs. Or they may prefer to buy an *exchange-traded fund*, which somehow manages to shadow the performance of a big price index (the Nikkei, the German Dax, or even just the price of coal), without ever buying even a single proper share. Weird.

The flipside of all these advantages is that investors need to be much more in touch with the markets than previous generations ever had to be. In the past, people bought old-style heavy manufacturing shares and kept them all their lives. But you don't have it so easy as your grandparents, because you have to live with a fast-changing world. China used to be a mainly agricultural nation, but instead it's becoming the world's number one producer of electronic goods. India and China have overtaken much of the developed world for steel and heavy machinery manufacture, and places like Mexico and Brazil are quickly dominating the international market for low-cost cars in the developing world. Chemicals, energy, mining companies – you name it, the geography of the industry is shifting fast. You have to listen out for the news in ways that nobody else has ever had to do.

You also have to understand information that would've baffled investors from previous generations: new terminology, previously unimagined techniques, fancy accounting systems, and lots and lots of politics. That's where this book comes in. But courage, you'll be fine once you get started.

Considering companies

Fortunately not much change has occurred over the years in the fundamental concept of a company. A *company* is an independent legal structure (a 'person', legally speaking), which belongs to its shareholders, whoever they may be, and not necessarily to its directors. If a company commits a crime, the directors can be jailed even though they may not own it. That's partly why they get paid so much. They're in charge of an asset that belongs to the shareholders and not to them.

When they make profits, the default assumption is that the board of directors hand out some of it to shareholders as a thank-you for their loyalty and an incentive to stay invested. This incentive is called a *dividend*. In practice, however, the board will generally prefer to hold at least some (or maybe even all) of the money back, in readiness for the day when the company wants to expand, or to buy up a competitor, or simply to go into a new area of business.

As you may expect, companies have debts as well as assets. Some of those debts (usually called the *current liabilities*) are due for repayment within the next year or so, while others (the *non-current liabilities*) can be rolled forward for many years. If you're sensible, you do your homework and get a general picture of how this 'legal person's' debt/asset situation really looks. In Chapter 17 I show you how to read a company's accounts, and especially its balance sheet, and how to read between the lines so that you get a better picture of what's really going on.

One day, the company will probably cease to exist in its present form. It might go out of business altogether, or (more probably) team up with some other company to form a new and bigger entity under a different name. In the second instance, your rights as a shareholder are transferred into the new company in one way or another. Maybe you'll receive shares in the new company, or maybe you'll get bought out with a cash payment that, with luck, will leave you handsomely in profit.

But in the event that the company really does go bust, you need to face the possibility that its investors may lose almost everything they've ever invested in it. That's just how it goes with red-blooded capitalism, unfortunately.

But hold on, surely you'd have some rights if your company went completely insolvent? Couldn't you demand at least some of your money back from the directors and all the other people who've been spending your cash or drawing it down in salary?

You'd better brace yourself. Your company is what's called a limited liability company (or, in Britain's case, more probably a public limited company, or plc) which essentially means that the law sets out very clearly how much it can end up having to shell out if the worst comes to the worst and the company collapses.

Usually, this means that the shareholders will be at the very bottom of the heap. The first people to get paid are the so-called administrators who get called in to sort out the wreckage and extract as much value as possible from the ruins, so that it can be fairly distributed to the right people. Next in line is the taxman. Then come the banks and anyone else who has lent the company money in the form of straightforward loans. Then come the bondholders and the preference shareholders who've invested money in special ways that give them so-called 'seniority' over other people. Somewhere in the line are the trade creditors – the companies who've supplied the failed company with goods and services that haven't been paid for. And right at the bottom are the poor ordinary shareholders who might have to settle for a tiny percentage of what they thought their shares were worth. Or, if they're really unlucky, nothing at all.

But we're in danger of frightening you off before we've even started, and that's really not the idea at all. A portfolio of well-chosen company shares will provide you with income (from dividends), or capital gains (from well-run businesses that will make your company worth more to other people), or ideally both at once. You can't get these sorts of returns on your money from *any other form of investment* – or at least, not without running a lot of risks that we really wouldn't advise you to take without a lot of thought.

But relax, you're among friends, and making good decisions really isn't as hard as I'm probably making it sound. It's just that there are a fair number of things you really do need to know before you start laying your money down on a portfolio of stocks. And a certain number of warning signs that you need to be aware of if you want to come out of it with a big smile on your face. My job is to take you through these things at a pace that won't leave you feeling daunted by a wall of detail. It can be done, and we're going to do it.

Finding out about financial institutions

I can't (and shouldn't) conclude this chapter without mentioning financial institutions. But where and what are they?

Like the proverbial elephant in the room, they're looking right over your shoulder, whether you happen to recognise them or not. They're the banks, the building societies, the pension funds, the insurance companies who make the pension funds work, not to mention the fund providers themselves, who are likely to be subsidiaries of the same banks, building societies, pension funds, insurance companies, and so on.

Plus the hedge funds that try to exploit minute differentials in the markets by slipping in and out, ideally while you're not looking (see Chapter 15 for more on hedge funds). Nobody has the slightest idea how much money the world's financial institutions control, but if you pick a figure somewhere in the £50-100 trillion region you're probably in the right ballpark. (America alone is estimated to have around £30 trillion in wealth assets, including property, of which more than half is managed by financial institutions.) And when it comes to the world's financial assets, you can safely assume that financial institutions control at least 85 per cent.

Now I'm going to say something controversial. I'm absolutely certain that with a bit of help and some study, most people can beat the majority of financial institutions. I can say that with certainty because of an inconvenient fact. *Most financial institutions perform less well than the stock market average*. Look at any ranking of fund manager performance, especially for unit trusts (see Chapter 6 for more on these), and you find that the average year's end performance is woefully short of what the stock market indices themselves have been doing (Chapter 3 covers indices).Which is a curious thing, because it means that somebody else must be doing better, or the averages don't mean anything. And that somebody else can only be private investors.

Institutions under-perform for the following reasons:

- Because they don't have certain essential freedoms that you do. (They can't hold cash for very long, whereas you can pull your money right of the market during financial droughts.) That cramps their style and gives you the comparative edge.
- Because they charge you fees that cut into your profits and may indeed chop them in half over the long term. Like a solicitor, they charge you these fees regardless of whether they make you money or lose it instead. Sometimes I think I'm in the wrong line of business.
- Because the really influential players are so large that their every move is scrutinised. George Soros or Warren Buffett can't turn over in their sleep without the Internet trying to second-guess what they're planning next. And Foreign & Colonial or Citicorp's funds are so vast that when they get rid of even a sliver of their holdings in a company, the news hits the global liquidity pool like a boulder falling from outer space. Everybody knows, instantly! So doing anything secretly is very hard for financial institutions, which also cramps their style.

Seeking Foreign Information

George Bernard Shaw declared that England and America were 'two great nations divided by a common language'. These two great nations have different laws, different tax systems, and different conventions regarding to talking about the financial markets. Just because the Internet encyclopaedia Wikipedia says something doesn't mean that the same necessarily applies to the UK, because the shading of the terminology might be subtly different – or indeed, completely different! If you act on a recommendation that's only going to be helpful to American investors and not to British ones, that's a real shame.

As a general principle, therefore, try to use online information sources that you know for a fact are written with the UK in mind. That doesn't mean that transatlantic information sources are unreliable, just that you should sometimes seek corroboration from these shores if you read something particularly arresting on a foreign website. That's a counsel of perfection, but one worth aiming for.

To avoid getting caught out by linguistic misunderstandings, include 'UK' when you look something up on a search engine like Google.