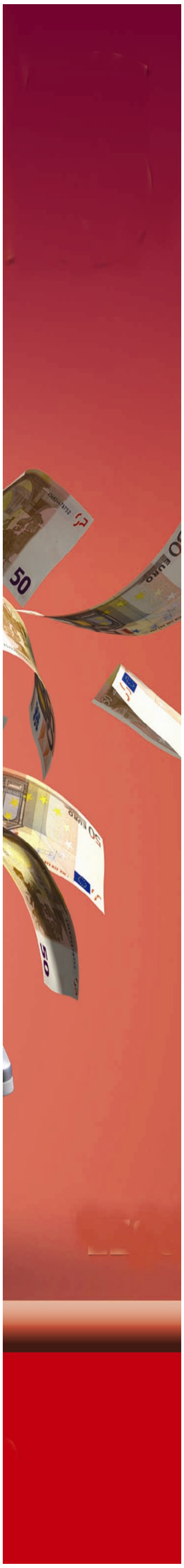
e-Wealth Secrets

By

Terry Mason

Lesson Five



Make Money From…Trading Stocks & Shares Online

Bring the City into Your Living Room…Trading Shares in Cyberspace

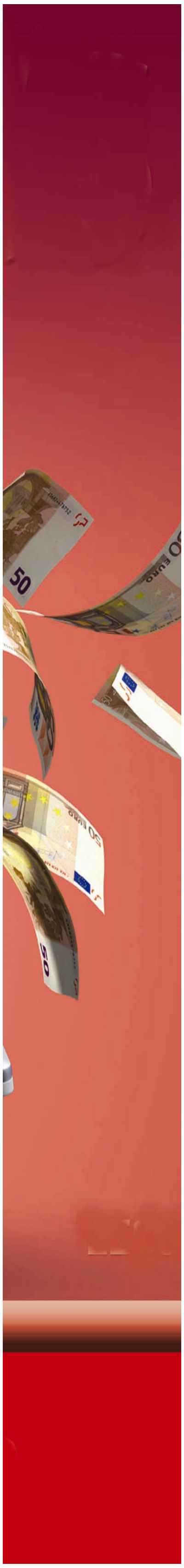
At one time, trading in stocks and shares was something only the already-wealthy could do. If you didn't have a serious amount of wealth – and a wealthy stockbroker willing to act for you – it was extremely unlikely that you'd be able to access the mega-profits that the stock market can reputedly offer.

The stock exchange 'Big Bang' in the 1980's – a process that made dealing in stocks and shares possible electronically for the first time – was the first step in making share trading accessible to all. Now the stock and share market is one of the most developed online markets there is, it is possible for anybody to buy and sell stocks and shares effectively, with no previous experience and very little money. The London Stock Exchange estimates that there are now over *100,000 Internet share dealing accounts* in the UK alone!

Internet share dealing offers you three big advantages: Firstly, the Internet offers fast transactions allowing traders to maximise buying and selling opportunities. Secondly, it allows you to trade cheaply, making small scale trading more cost effective than ever before. But the most important development is that high quality information on 'good buys' and 'must sells' is now available not just to the big City trader but to anyone … anyone with the good sense to take advantage of the profit making opportunities!

With Internet share dealing one of the problems is that there is often just too much information. You have to know how to select it, as well as use it. In this lesson I won't give you any investment advice. But I will show you how to take advantage of today's modern Internet share information and trading system to maximise the profits from your own investment judgements.

Over the last few year's stocks and shares haven't proven to be as profitable as the previous decade. But just remember this: History has proved that over the long term shares produce far better gains than other assets such as cash, bonds or property – even if they fall sharply in the short term. Research by Credit Suisse First Boston, an investment bank, has shown that since 1869 shares have produced an annual return of 6.2% ….far more than the interest rates offered by most savings accounts. And, one of the best things about the Internet is that it allows shrewd dealers to make money whether the market is rising, falling or doing nothing in particular!



If you feel that you lack the experience to make real money from stocks and shares then consider this case history: A group of teenagers from Chesterfield College in Derbyshire recently made a massive *201% profit* as part of the ProShare Student Investor Programme! The students were given a 'virtual portfolio' of £100,000. They strategically managed and monitored their investments over seven months after which their portfolio was worth £300,779.42! (The FTSE All Share Index only rose by 4% during the same period.)

Getting Started Easily and Simply

Finding and Choosing an Internet Stockbroker

To trade shares you will need a stockbroker. But unlike in the old days you won't need big City connections as making use of Internet stockbroking services is easy. Everything can be done online and you won't ever meet or speak to a broker if you don't want to. Some Internet stockbrokers are listed in the Appendix. For a free list of brokers and the services they provide, you can also contact the Association of Private Client Investment Managers and Stockbrokers (APCIMS), and you can find many more using a simple Internet search.

In The Internet age stockbrokers fall into one of three types:

<u>One:</u> Management Broker. Your stockbroker buys and sells shares for you as and when they see fit (and without the need to obtain approval for each trade) in order to maintain a portfolio in line with your overall investment objectives. *Few small online traders use this type of service.*

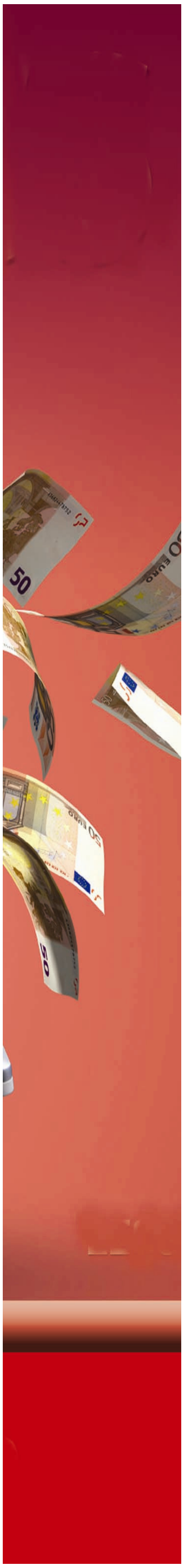
<u>Two:</u> Advisory Broker. Your stockbroker will give you advice on buying and selling when you ask for it, although you are still responsible for making all final investment decisions. Some small online traders use this type of service.

<u>Three:</u> Execution Only Broker. Here your stockbroker will provide you with *no* advice on your investments or your portfolio. You alone decide what to buy and sell and the broker simply handles the transaction for you. *Most small online traders use this type of service.*

The type of broker you use will depend on your know-how and the amount of work and/or research you are willing to do yourself. Using an execution only broker is the simplest and cheapest option but you'll need to do more work and research yourself to succeed.

Opening an Account

Before you can begin trading on the Internet you'll need to open a *trading account* with an online stockbroker or brokers. You can open as many accounts as you like but it is usually easier to concentrate all your dealings in just one trading account.



When opening a trading account check to see that the services provided will allow you to do what you want to do with your share investments. For example TD Waterhouse, a major Internet broker, offer the following in their execution only General Trading Account:

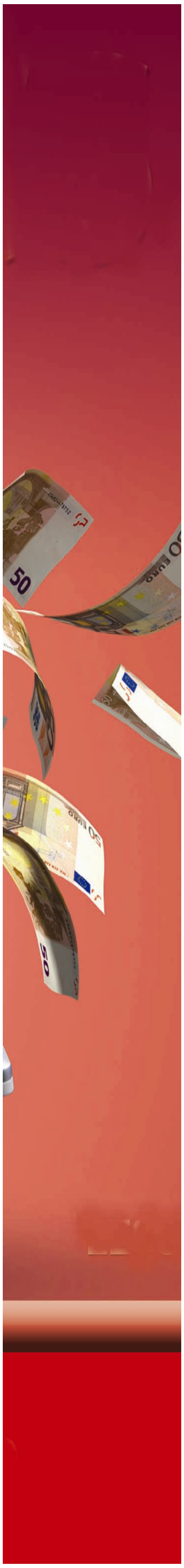
- Ability to trade in a range of investment options: UK equities, gilts, bonds, investment trusts, unit trusts, OEIC's and Exchange Traded Funds. (In this lesson we will mostly study investing in UK equities – commonly known as 'stocks and shares'.)
- Online and telephone access.
- Extended trading settlement (see later).
- Online research tools.
- Nominee facilities (see later).
- Cash management and banking facilities.
- Real time quotes online or by telephone.
- Ability to place limit orders (see later).
- Ability to create virtual portfolios and track performance.
- Additional services available, including: International dealings, covered warrants and derivatives.

Most online trading accounts require you to deposit investment funds with them before you can make a trade. However, there are some which operate like a traditional stockbroker where you can make a trade and 'settle up' later.

Costs & Fees: How To Save Money Online

The cost of Internet share trading depends on the type of service you use. With small scale Internet share trading always aim to keep costs to a minimum. Dealing costs, commissions, fees and taxes come out of the profits you make on investments so, effectively, your shares have to gain in value just to break even. Then again, cutting costs by not taking advice when it is needed can be a false economy.

If you use a management broker then you should expect to pay around 1.75%



commission, plus lump-sum fees for any specific advice. An execution only service is likely to cost around 1%.

However online execution only stockbroking is a very competitive business. A number of Internet brokers operate flat fee trading, e.g. £7.50 to £12.50, regardless of the size of a transaction. They may also offer a number of free trades when you first open an account with them, or fees might reduce the more trades you make. It makes sense to review the charges you pay from time to time, or operate several accounts, to ensure you get the very best deal. Charges can eat into profits, so get a good deal.

How To Trade Shares on the Internet

Buying and Selling Made Simple

In most circumstances buying and selling shares online is just a matter of accessing the Internet, logging onto your account and indicating the shares you wish to buy or sell and the quantity involved. Usually you'll be asked to give the official 'EPIC' code, a unique three or four letter code for each Stock Exchange listed company. If you don't know the EPIC code most brokers' sites have a 'look up' facility.

There are generally two types of order you can make: A *best price* order means that the broker will buy or sell at the best price available at the time they process your order. With Internet share trading this will normally be almost immediate. (There might be a short delay and many brokers only guarantee to process your order within 30 minutes or so, by which time the price could have changed!)

Most Internet stockbrokers allow you to place orders at any time of the day or night which is very convenient. However, remember that stock exchanges are not open 24 hours. If you place your order when the market is closed it will not be acted upon until after it reopens, by which time the price could have changed!

The other kind of order is a *limit order*. This means that the shares are bought or sold if and when they reach the price you have indicated. (Otherwise nothing is bought or sold.) This is a useful type of order if you must buy or sell at a given price, or if placing orders outside stock exchange hours.

It is also worth thinking about the time of day at which you trade. In the first and last hours of trading (before 9am and after 4pm in London) the volume of trading going on can be lower than other times and prices can be more volatile. This means that the spread between the bid and offer prices – the prices at which you can sell and buy – is often wider too. This particularly applies to shares in small companies.

With online Internet share trading services you won't usually receive a paper contract note or share certificate. All your transactions will be confirmed by e-mail and recorded online within your account.

Settlement: What It Means

It is a stock exchange convention when buying or selling shares that settlement (or payment) occurs after a set period of time. This is now normally three days and known as ‘T+3’. When trading online your transactions will be debited or credited to/from your deposited funds or cash management account at settlement.

If selling the shares, you must ensure that your stockbroker has access to the necessary share details, so that they can transfer them to the new owner and collect the money due to you from the sale. Again there is a three day time limit to complete the settlement.

Some stockbrokers can provide longer settlement periods. If you wish to take advantage of such a facility then check with the stockbroker but note that the dealing costs may be higher.

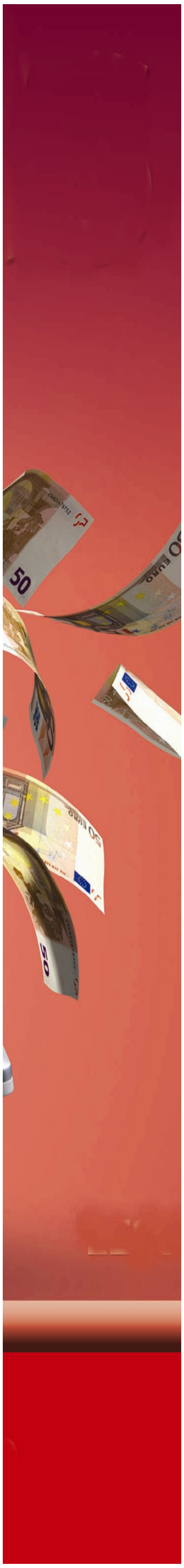
CREST: What It Means

It is still possible for you to hold shares in a paper certificate form, and for this paper certificate to be sent out/returned when you buy/sell shares. However, many Internet stockbrokers do not offer this option and those who do may charge you a higher commission and/or dealing fees. Instead, they use CREST. CREST is the electronic system created for transferring UK shares between the buyer and the seller. It was introduced by the Stock Exchange in 1996 to replace the paper-based settlement system for shares traded in London. It is quicker and cheaper than paper-based methods and this is reflected in the lower fees offered by online brokers. CREST has also proven to be perfectly safe and secure and unless you have a particular reason for wanting a paper certificate (eg. sentimental or novelty value), it is satisfactory for most needs.

Nominees: What It Means

A nominee is a company created for the purpose of holding shares and other securities on behalf of investors. It is usually operated by a stockbroker or a bank. Most Internet stockbrokers require that you hold your shares under the name of a *nominee service* to facilitate quicker buying, selling, settlement and administration. (It is possible to own shares in your own name if you wish, but this may involve higher fees.)

In these situations, the nominee is actually the legal owner of the shares but the so-called ‘underlying investors’ (you) have the beneficial interest in the shares, i.e. the right to sell them and receive dividends. As with CREST, the nominee system has also proved to be perfectly safe and secure and, unless you have a particular reason for wanting your shares to be registered in your name, it



is satisfactory for most needs.

There are a few points to consider before using a particular nominee service:

- What are the charges, if any? It is preferable to use a service which doesn't charge.

- Will you continue to get all information, company reports and announcements? Many nominee services do not forward them unless you specifically request it.

- How often are your dividends sent? This may not always be immediately they are paid by the company.

- How much insurance does the broker have to guard against fraud or bankruptcy of the nominee service? Note that if there is no other insurance in force the Investors' Compensation Scheme only covers investments up to £48,000.

Important Tax Considerations

Trading in shares involves a tax liability but can also offer tax benefits. Before you begin trading in them it is important to consider what these will be, so that you can *plan your trading to maximise the advantages and minimise the disadvantages.*

Stamp Duty: When you instruct an online broker to buy shares for you, as soon as they complete the transaction, you will be charged either Stamp Duty (if you purchase the shares outside CREST) or Stamp Duty Reserve Tax or SDRT (if you settle within CREST).

Currently Stamp Duty is charged at the rate of 0.5% on the value of your purchase, but there is a minimum duty of £5 and the duty is also rounded up to the nearest £5. Stamp Duty Reserve Tax is charged at the same rate as the Stamp Duty on a paper transfer except that it is solely the 0.5% rate as an exact amount, and not the rounded-up value, that is due.

Income Tax: Assuming that the company in which you have invested does well, then you can expect to receive a dividend twice a year as a reward for investing your money with them. Dividends are subject to Income Tax alongside all your other income. A basic tax or 'tax credit' is deducted from your dividend before you receive it, so that basic rate taxpayers have no further tax to pay. (If you are not a taxpayer, then, unfortunately, you cannot claim this back!) If, however, you pay tax at the higher rate, you will have further tax to pay at your higher rate when you complete your tax return.

Whatever your tax position you should keep the voucher for the tax credit, which will be sent to you annually by the company, so that you can produce this for the Inland Revenue if required.

Capital Gains Tax: When you sell your shares you may have to pay Capital Gains Tax (CGT) on your profits. Generally, you are liable to pay CGT on any capital gains you make during the tax year. However, if your total gains in the year fall below the current annual exemption limit (£8,200 in the last tax year), then you are not liable to pay any CGT. If your total gains are above this tax free level, CGT is based on the top rate of income tax applicable to your other income. Broker's charges and stamp duty may be deducted.

If, unfortunately, you have made a loss when you sold the shares, then you can offset this loss, including the dealing charges, against any other gains you made. If you have held the investment for some time, then there may be further relief due to you in the form of Tapering Relief.

Individual Savings Accounts (ISAs): Stocks and shares ISAs allow you to hold a limited shareholding without having to pay tax on the profits from them. If you do not already have a stocks and shares ISA, you should always take advantage of the tax shelter afforded by them. You can get more information on the rules and limits applying to ISA's from the Inland Revenue.

Useful Success Strategies for Internet Share Trading

Thousands of books and articles have been written advising on the most successful investing strategies – and you can find lots of advice with a simple Internet search. However, these basic investing strategies are widely accepted by experts and will help to guide you.

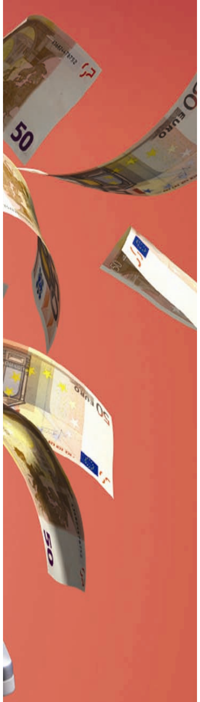
Risk, Growth or Both?

Different investors have different investment strategies but they basically fall into three groups: Do you want to produce an *income, grow your capital, or a mixture of both?*

To generate a significant income from a smaller investment, you'll need to buy and sell frequently; looking for shares whose price is likely to rise quickly in the short term. This will generally be more risky. To achieve growth, however, you'll need to minimise trades and look for shares with good long term potential. If you want to achieve both, decide what percentage split you wish to aim for (i.e. 60-40 or 50-50) and try to stick to this.

Balance Your Portfolio

Invest in shares in a number of different companies and from different industrial sectors of the market. If one share, or one sector, performs badly, then you have balanced this with the gains you are hopefully making in your other companies and sectors.



As a general rule, you should aim to hold shares in at least six different companies in your portfolio at any one time. These should be in at least three or four different sectors, i.e. not all in 'property' or 'finance'.

You can limit the effects of buying riskier shares, by purchasing a similar value of shares in 'blue chip' larger companies. Large, well established companies with a good reputation should maintain their value over the longer term, although you're unlikely to make a big short term profit (of course, there are always exceptions to this rule!).

Avoid Timing the Market

Over the years, many experts have tried to make big money simply by buying anything and everything when the stock market is depressed and then selling everything when it rises. While you can make money from fluctuations in individual shares market timing rarely works as a wholesale strategy – so avoid it!

Buy Little and Often

Smaller investors often find it is effective to buy shares on a regular basis, i.e. once a month, once every six weeks, or once every three months – **regardless of prevailing prices**. This takes advantage of a phenomenon known as *cost averaging*. By buying on a regular basis you will always be buying at an average price.

Take a Long Term View

While you can make profits by quickly buying and selling shares, most experts recognise that holding your investment for five years is most likely to maximise your gains.

Don't pay too much attention to the daily fluctuations of stock market prices (if you take a long term view you won't really need to). If your original reasons for selecting the company appear sound, and nothing has happened to adversely affect its value and performance over your five year time span, than it can be safe to assume that today's adverse fluctuation will swing back eventually.

Watch Your Dealing Charges

This is especially important for the small trader. However, Internet trading is a good way to control them. Charges should be no more than 1.5% to 2% of the total value of your order. Remember, your investment has to grow by a significant amount to cover these costs and put you into profit! Even if you are satisfied with your execution service, keep looking for more economical ones, as the pressure is on charges to move down not up.

Have a Few 'Long Shots'

Even if a substantial part of your portfolio consists of relatively safe shares, it adds interest to your investments and can also be very profitable, if you buy some shares in a few ‘long shot’ companies. These may be new, start-up businesses – or alternatively old, failing businesses – where the likelihood is that if they don’t go bankrupt the only way is up. Long shot investments are highly risky of course, but in some cases can show returns of thousands of percent in a matter of months – something blue chip shares will never do.

The secret with long shot investments is never to invest more in this type of share than you can afford and are willing to lose.

Harnessing the Power of the Internet as a Research and Investment Tool

The Pros of Investing on the ‘Net…and the Cons

Good information is essential for good investment. You need it to help you reach an informed decision on what and when to buy, on what and when to sell, on what is happening to your investments and the market and, ultimately, to tell you how successful you have been and how rich you are getting! If you are using an execution only online share trading service, it is especially important to get good information as your broker won’t be able to give you any advice.

The Internet has resulted in a truly phenomenal change in the information available to the small share trader, so that it is now possible for you to have the same (or occasionally better) information than the big City dealers. However, there are also a few drawbacks of the Internet age to be aware of.

The first problem to tackle is the sheer volume of information available to you on the Internet. One solution is to avoid generalising. Try to specialise in a small but balanced range of sectors and use information sites tailored to those sectors. Many of the Internet sites specialising in investment, are designed to suit all types of investor and all types of investment management activity. However, the ‘one stop’ approach, whilst appearing very comprehensive and user-friendly, may not always provide the best answer for each individual investment strategy.

Secondly, the Internet offers a good deal of free information. But remember, really *good* information, and the means to use it most profitably for you, is often not free. You should expect to pay for top quality, up-to-date, detailed analysis and information. Increasingly, the more timely and valuable information can only be obtained through premium websites, following payment of a monthly or annual subscription. However, if the information is going to give you an advantage, then this may be a small price to pay for gaining that advantage – very often much less than a stockbroker will charge for the same information.

One of the most important points to bear in mind when gathering share information from the Internet, is that it is sometimes out of date. In particular, share price information on many sites is *generally delayed for at least 15 minutes before it is released for you to see.* This delay is a commercial, not a technical, one: Immediate share prices are valuable and are *sold* to customers by stock exchanges, not given away. After 15 minutes, the stock exchanges, who supply the feeds to the information and media companies, consider the information less valuable and are willing to 'give' it away.

To obtain genuine real time share data you often have to pay for it. And always check to ensure that an information service described as 'real time' really is.

Lastly, and very importantly, even in the Internet age you will find good sources of information that are *wholly or partly offline.* So, do not overlook these.

In this section, we will study the different types of information sources (online and offline) which you can use:

Newspapers

The Financial Times (or FT) is the main daily newspaper for investment news and information. It is as much useful reading for the serious private investor, as for the professional fund manager. Its London Share Service pages give closing share prices and key valuation statistics for some 3,000 companies, both large and small, thousands of investment funds and also coverage of the prices of shares of the major international companies traded on foreign stock exchanges.

The FT Internet site features *most* of the information and news contained within the paper. (Some free, some charged for on subscription.)

Most other daily newspapers have some share information and even a tipping service. But bear in mind this is often very selective and the information selected, may not match up with your own individual investment strategy.

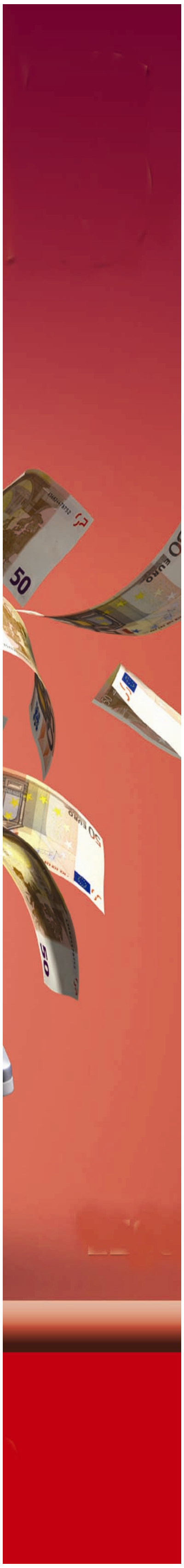
Personal Finance Magazines

There are now a large number of weekly or monthly investment-related magazines available, some of which you can find in a newsagent and others which are available on subscription. Most of these have an online version too – see the Appendix for contacts –although you have to pay a subscription for more than basic information. Here are some suggestions:

Bloomberg Money: Monthly magazine. Covering all aspects of 'your money' with particular emphasis on shares.

Citywire Insider: Share tips, features and money-making ideas based on the trading activities of top stock market investors. Features 'secret' buying techniques and shrewd investing strategies which you can copy.

Investors Chronicle: Published every Friday. Regarded as the 'private investor's



bible'. It provides company news and profiles, tips on shares and broker recommendations, articles on investment strategies and useful statistics.

Money Observer: Monthly magazine providing information and analysis as well as expert, unbiased opinions on investment. Also offers a useful e-mail newsletter.

Moneywise: Monthly magazine that covers all personal finance subjects with specific coverage of stock market investment. Free Internet site.

Personal Finance & Savings Magazine: Monthly magazine covering mainly personnel finance matters, but also with coverage on stock market investment.

Shares Magazine: Published every Thursday. Takes a user-friendly approach to stock market investment. It contains company news and profiles, share tips and has regular investment club coverage. Its Internet site (Money AM) gives daily news announcements and similar updates.

What Investment: Monthly magazine. Well respected and innovative magazine, with a stock market section and features on unit trusts and other aspects of investment.

Newsletters and Tip Sheets

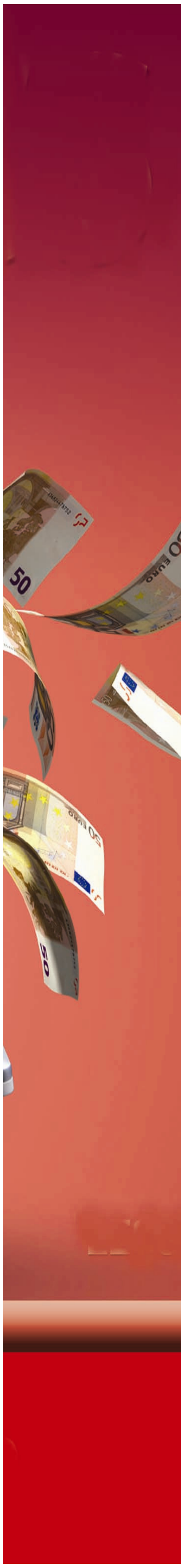
There are now a large number of investment newsletters (often called 'tip sheets'), sold on subscription and published both on paper and online. There are too many to list here, but you can find a good selection from searching online, or through their advertisements in finance-related newspapers and magazines. Many of them are quite specialised, covering a particular sector of the market, or providing information for a particular type of investor, so it is always best to obtain a sample issue before subscribing.

Before taking up any of the advice in a tip sheet it is advisable to test its quality first, ideally using a *virtual portfolio*, which are offered by some Internet stockbrokers.

Teletext and Ceefax

Teletext and Ceefax are in practice a basic form of 'online' investment information services. They are so long established that they are a well-respected source of financial information yet they are also free!

Teletext: Channel 4, from page 500 onwards. The service features include 400 leading share prices updated every 15 minutes, but with all prices also delayed by 15 minutes and 3,000 shares (virtually the total market coverage), updated at regular intervals eight times daily. Also major company news and personal finance information and news at page 490.



Ceefax: BBC1 and BBC2 page 200 onwards. Company news and announcements are featured together with updates on share prices (usually at least 15 minutes delay).

TV And Radio

The most useful programmes are:

TV: 'Business Breakfast' (BBC1 at 6.15am, 6.45am and 7.50am Monday-Friday) and its associated programme 'Working Lunch' (BBC2 12.30pm Mon-Fri) provide up to date stock market and business information. As well as the UK, these programmes also cover international market reports and news. BBC2's 'The Money Programme' is a leading source of 'behind the scenes' business stories.

Radio: 'Money Box' (BBC Radio 4 at 12noon Saturday and 3pm Monday) is a well respected programme for financial and investment stories. Also, available is 'Wake Up To Money' (BBC Radio 5, 5.30am Monday-Friday).

If you have access to satellite or cable TV, then many of the specialist news channels provide comprehensive financial and business news continually throughout the day.

Premium Rate Telephone Lines

Premium rate telephone lines usually provide *real time* share prices and financial news. In today's Internet age, the main advantage of accessing information in this rather old-fashioned way, is that it is a simple way of paying for information on an 'as you need it' basis – rather than paying for subscription to an online information source you might not use very often.

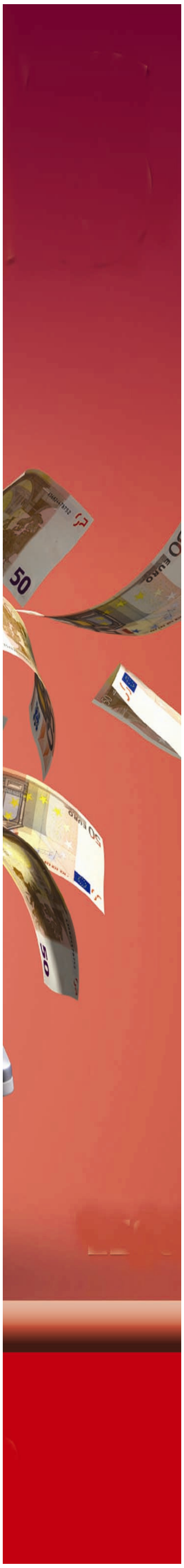
The following services are suggested:

FT Cityline provides individual share prices and market statistics through a conventional or mobile telephone or fax machine. You can get details from the FT Cityline website.

Several national newspapers also have share information lines.

Company Websites

If you're planning to invest in a particular company; always visit the *company's own website*. Many of these have sections specifically identified as 'shareholder relations areas', providing copies of news stories, Annual and Interim Reports and latest share price information. Even if they do not have specific investor information, these sites are still worth a visit as a means of identifying what the company does and the markets it is trying to attract.



A company's Annual Report and Accounts is its primary medium of communication with shareholders. As a shareholder you are legally entitled to receive a copy each financial year. (However, if you hold your shares through a nominee you may not receive a copy automatically because the company and its share registrar do not always have your address.) Even if you are not yet a shareholder in the company, you can obtain the latest Annual Report either online, or on request from the company secretary or share registrar.

Online Services

In the past few years the Internet has developed into the primary information source for both professional and amateur traders. So great is this topic (and so liable to change) that I have listed a selection of online services and useful websites in the Appendix.

More Information: If you require more information, ProShare, an organisation which supports small investors, publishes a comprehensive guide to all the information sources available. For contact details for ProShare, see the Appendix.

In the next part of this lesson, we will look at some alternative methods of profiting from stocks and shares, other than simply buying and selling, and building a conventional share investment portfolio. Although the Internet has single-handedly made some of these sophisticated methods accessible to ordinary and small traders, it should be noted that they are much more risky than simply buying and selling shares.

Financial Arbitrage: What It Is and How It Works

In the last lesson, we discussed how arbitrage can be used in sports betting. However, there are also arbitrage opportunities in financial markets. Most of these opportunities come from the fact that there are many different ways and markets to trade what are essentially the same stocks and shares or other financial commodities, and many different assets are influenced by the same factors.

Financial arbitrage has boomed with the rise of global trading and the widespread use of the Internet. At its simplest, it involves trying to buy something cheaply in one place and then making a profit selling it elsewhere. In share trading, arbitrage has also come to mean a sophisticated form of *betting*. Traders called risk arbitrageurs, attempt to make profits from an expected rise in the price of a takeover target's shares and a drop in the price of the bidding company's shares. These traders simultaneously buy stock in the target while selling that of the bidder. They will also invest in the target company if they think the bidder will be forced to raise their offer price.

However, given the speed at which the electronic financial markets now operate (in practice trading in stocks and shares, securities, currencies, commodities or any other financial instrument is *almost* simultaneous), financial arbitraging calls for quick thinking and quick action. Often it's necessary to complete both ends of the transaction within a few seconds. As margins are also slim, it's usually necessary to make very large trades. Or, if you do not wish to expose yourself to as much risk, a high volume of smaller trades. The cost of making transactions, such as fees and taxes, must also be factored into the equation and this explains why arbitraging is most popular amongst Internet traders, where costs are lower.

The possibilities for arbitrage are everywhere, from financial wizards selling complex derivatives ….to collectors selling fountain pens on eBay! Here are a few examples from the financial markets:

- Currencies: In the international currency markets, there may be a time when Sterling is being quoted at slightly different rates by markets in (say) London and New York. If, for example, you could buy one pound in London for $1.7030 and at the same time the selling price was being quoted in New York at $1.7040, as a skilled trader, you might buy currency quickly in London and sell in New York.

- Options: A call option is the right (but not the obligation) to buy a share at a price given in the option. Suppose Microsoft is selling for $200 a share, and an option which allows you to buy one share of Microsoft stock at a price of $120 is selling for $50. You buy the option for $50, then exercise the option and pay $120 for one share of Microsoft stock. You now own one share of Microsoft stock, and have paid $170 for it. You can then immediately sell the stock for $200, making $30.

- Convertible Bonds: Instead of using options, you can also perform a similar type of arbitrage by using convertible bonds. A convertible bond is a bond issued by a company which can be converted into the stock of the bond issuer. This type of arbitrage is known as convertible arbitrage.

- Shares and Share Indices: Index funds are financial products that are, in effect, 'shares' which are designed to shadow the performance of a stock market index. An example of such an index is a 'diamond' which shadows the performance of the American Dow Jones Industrial Average. Occasionally the price of the Diamond will not be the same as the 30 stocks which make up the Dow Jones Industrial Average.

If this is the case, then an arbitrageur can make a profit by buying those 30 stocks in the right ratio and selling the diamonds (or vice-versa). This kind of arbitrage is especially complex, as it requires you to buy a lot of different assets, but can be extremely profitable for experienced traders.

Note that most arbitrage profits are generally short-lived, as the buying and selling of assets will change the price of those assets in such a way as to eliminate that arbitrage opportunity. However, none of this has seemed to deter the tens of thousands of traders, amateurs and professionals, who look for arbitrage opportunities every day.

Day Trading: What It Is and How It Works

Day trading has always been possible, but the Internet has opened it up to the private individual. In fact, new technology including real time quotes, state of the art decision support systems, charts etc., has put the small, private day trader on the same footing as the City professional and, in the right circumstances, allowed them to make the same profits from a very small outlay.

Day trading is the buying and selling of stocks quite literally *during the stock exchange's trading day.* Day traders aim to make small profits on a large number of 'intra-day' transactions. They follow the markets, use computerised technical analysis to identify price trends, and get 'in and out' very quickly. The aim is to make a profit on the day and only on the day. Day traders rarely if ever have any open positions (i.e. shares in their portfolio), at the close of the trading day.

In the late 1990's and early 2000's the stock market moved between fast rising and volatile. Both are excellent climates for the day trader to succeed in relatively easily, and many day traders made hundreds of thousands of pounds a year as a result. In today's slower stock market, however, day trading is less of an opportunity. But it is always useful to know about the possibilities for when favourable market conditions appear once again.

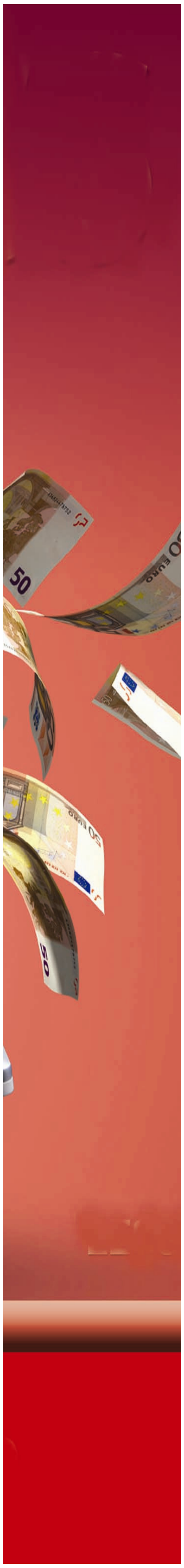
Day trading is always an extremely risky activity. The need to hunt down fluctuations and buy and sell within the sale locks you out of the long term thinking, which is usually the best strategy for succeeding in share trading. However, if you are interested, here are some pointers:

- Don't trade what you can't afford to lose. (Applies to all kinds of investments.)

- It is essential to have access to real time market information, quoting and dealing services. Use the very best Internet access, information and dealing sites and technical analysis/management software available. (You will usually have to pay for these, as free sites are rarely quick enough.)

- To day trade successfully requires good analytical skills, the ability to develop and follow a system, and stamina. Not everyone is suited to the physical and mental demands it makes.

- Don't rush in without careful thought and preparation: Read and research as much as you can about target shares, using all the usual information



sources. Be cautious about purchasing day trading ‘systems’ – they aren’t a substitute for personal knowledge and commitment.

- Watch your dealing costs. The difficulty for UK day traders is that dealing costs are still relatively high, and stamp duty reduces the margin of profit on each successful trade. In the USA, where costs tend to be lower than in Europe (and traders can also link direct to the markets), it is more rewarding.

- Day traders should always have sufficient liquidity to exit a position if they need to.

- Profitable markets always move quickly and professional dealers may be much further ahead of you, no matter how quickly you react. Day traders need to watch quotes and price fluctuations continuously. They must be able to move quickly if necessary.

- Some day traders buy stock with borrowed money or sell stock they do not own (known as ‘going short’). This is extremely risky. If things go wrong day traders can lose a lot of money – and very quickly!

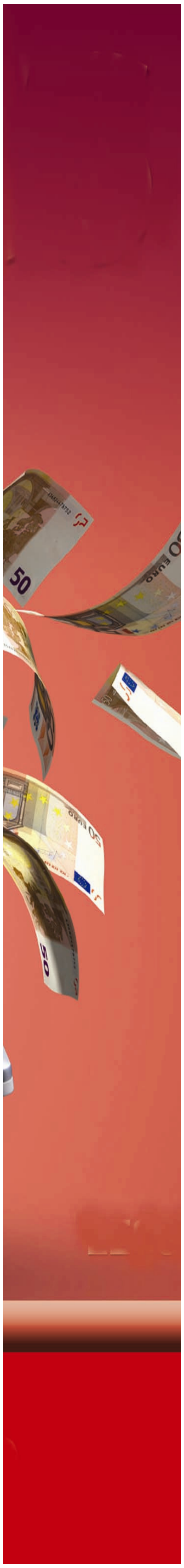
Penny Shares: What They Are and How They Work

Penny shares are not literally shares that you can buy for a penny! However, what are commonly known as penny shares can offer potential for traders who take the trouble to understand them and make use of modern Internet trading technology to exploit them. Although they are not necessarily available for little cost, they are still very accessible for the small trader.

Many stockbrokers consider a penny share should not have a value of more than £1, although some regard the limit as £3. However, the Financial Services Authority (FSA) simply designate penny shares as any shares with limited liquidity, i.e. they are hard to buy and sell in quantity without the sale affecting the price. Specifically, the FSA has identified shares with a spread of more than 10% between the buying and selling prices as having the characteristics that make a penny share.

The most important thing to remember is that, regardless of the price, the rewards in penny shares arise partly because they have what is known as a ‘thin’ market that is easily influenced. For example, a share priced at 10p may rise 50% on good news, whereas a ‘blue chip’ share certainly will not. (Conversely, a penny share can fall more sharply in percentage terms than a blue chip share.) They are attractive to shrewd traders because the price at any given time may bear no relation to the stock’s underlying value.

A classic penny share profit situation arises when predators show an interest in a company. The share price can soar on speculation that there may be a



contested takeover bid, at a considerably higher value than the current share price.

Penny shares often attract ‘fun’ investors, but offer a serious opportunity too. You need to be ready to move in and out of stocks, keeping a sharp eye on share price changes. Though you will find some penny shares in which it is worth investing for the longer term. One important guiding consideration is that the younger the company in which you invest, the greater the risk.

When buying, the choice of markets is large. A company may be listed on the Alternative Investment Market (AIM of the London Stock Exchange), or instead on the Off Exchange Market (OFEX). Some stocks are listed on a market or trading facility abroad, or are not listed anywhere.

Opportunities in Penny Shares

There are several categories of penny shares and associated opportunities:

<u>Recovery Stocks:</u> Recovery stocks are in companies which have once been successful stocks, but which have fallen out of favour. Often, they were once ‘stock market darlings’. The companies have often survived only because they have sharply restructured their business.

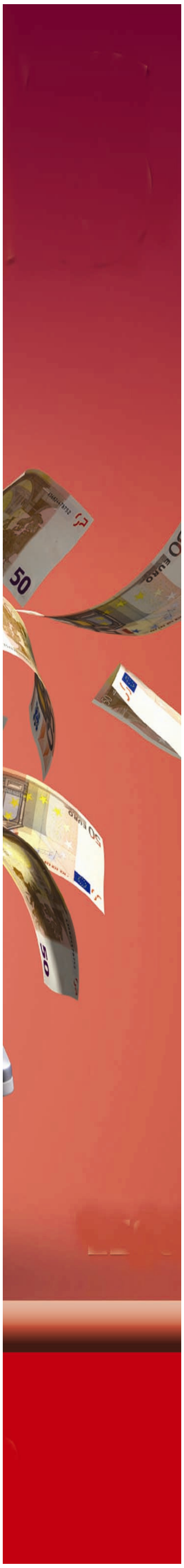
<u>Cyclical Stocks:</u> Cyclical stocks rise and fall in value with the normal business cycle. For example, airlines and travel companies usually perform much better in the summer than in the winter and their share price often fluctuates to reflect this. Property company shares are another good example, where building companies may scale down their operations ahead of an anticipated slow down in the housing market.

<u>Dot.Com Stocks:</u> E-commerce companies are exceptionally volatile and often have few tangible assets as such. Values can rise or fall rapidly within a matter of weeks. This could be for company-specific reasons, but more often occurs due to trends in the sector as a whole.

<u>Biotechnology Stocks:</u> New biotechnology companies are traditionally a high-risk investment. Fewer than 10% of their products ever reach the market, although the success rate improves the longer they survive. Look for biotech stocks where the company has more than one product, or where there is a link with an established company.

Choosing Penny Shares

In selecting penny shares for investment, remember that they are not subject to the usual stock valuation rules. The conventional measure of ‘PE Ratio’ (Price to Earning) for example, is rarely valid as the share price is so susceptible to the feeling in the market which may be no more than a ‘gut reaction’.



A penny stock will ideally have a net asset value per share that is higher than the share price. This will minimise the chances of it failing completely and of you making a loss. (If a company is wound up, the liquidator will distribute to shareholders in proportion to the company's assets.)

Do not focus too sharply on asset backing, especially in a dot.com type company. Compared to traditional companies, it may have few assets, or even none.

When considering stocks, it is better to look ahead rather than consider past performance. If, for example, you discover that the company is about to launch a promising new product, but details have not yet been released, consider investing immediately. If, however, the product has been touted around for months as something that will turn the company around, be sceptical.

Assess the company's management. Look for leadership skills as well as knowledge of the business in question. Remember that a positive change in management can be enough to send the share price soaring.

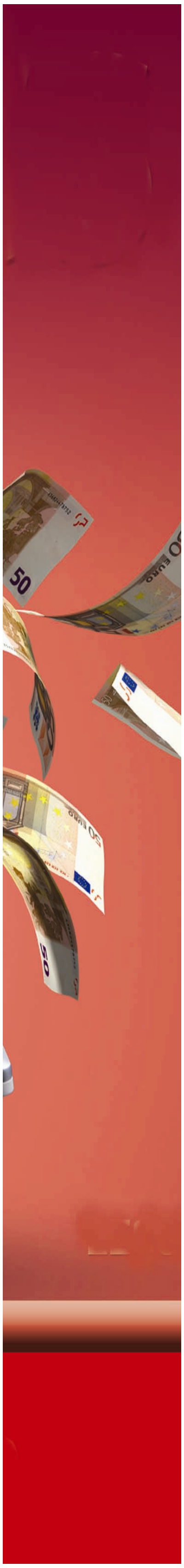
Most important of all, do your own research and be prepared to act on rumour which is usually not advisable, but for penny shares can be effective. Use what you read in the press or newsletters sparingly. Often, with penny shares, it is *small traders* who discover them first, buy in, and then take the profits when the newspapers and newsletters first mention them.

Contracts for Difference: What They Are and How They Work

Contracts for Differences, or CFD's, are one of the fastest growing financial products in Europe. Fast, efficient Internet-based information services have made them available to much smaller investors than previously was the case. They offer relatively small investors a chance to play the stock market in a very big way.

A CFD allows you to invest in a share without actually owning it! Instead you agree with a CFD broker to 'buy' at the current price. When you sell, you settle the difference in pence or index points, multiplied by the number of contracts you bought. You don't have to pay the full cost of the investment, as most CFD providers require only a 10% deposit. In other words, using leverage, you can control *ten times as big an investment* as you could otherwise!

For example, if you bought a single contract of HBOS, equivalent to 1,000 shares, at 700p per share and sold them a few days later at 730p, you would have made 30p x 1,000 shares, or £300. (By contrast, if they fell to 690p when you sold, you would have lost £100.)



CFD's offer four distinct benefits to investors: They offer margin trading – you can trade with up to 10 times the exposure of your initial deposit, the ability to 'go short' and also avoid stamp duty. Their artificial construction also makes it just as easy to profit from falling markets as rising ones. (Going short, the process by which you sell something with the idea of repurchasing it more cheaply later, is easily accomplished.)

CFD's are a sophisticated vehicle. Used successfully, they enable investors to benefit from short-term price movements in either individual shares or market indices, and allow them to replicate the huge trading volumes of institutional investors. However, they are also *very high risk,* with the possibility of losing more than you actually invest. This makes it even more essential to be well informed and disciplined than with conventional share ownership. The volatility of CFD's, means they are suitable for experienced investors who are willing to accept high risk, short-term profits, and those who have the time to use the Internet to monitor markets constantly.

For those that are new to CFD's, it is advisable to use a trading account which offers automatic stop-loss. This ensures that your losses are limited to a pre-determined amount (often 10-20% below the price you paid), as loss making positions are closed automatically.

In the past CFD's have only been available through specialist brokers, but they are now being offered by mainstream and even discount stockbrokers such as TD Waterhouse and Selftrade. Note that the Financial Services Authority (FSA) requires brokers to satisfy themselves that a potential client has experience of margin trading when opening a CFD account.

Also note that spread betting – which we looked at in Lesson 4 – can be an effective way of profiting from stocks and shares, and works in a very similar way. A spread bet is by definition a type of CFD.

There are several big companies such as IG Index in London who specialise in handling spread bets from all ranges of customers.

Risks of Internet Share Trading: What You Need to Know

While the Internet is undoubtedly an excellent source of information on shares and investment there are some special risks relevant to share trading information found on the Internet and which it is important to be aware of.

Financial websites, bulletin boards, chat rooms and Internet newsletters can be good for information, tips or gossip. But it isn't always reliable. Although the Financial Services Authority (FSA) regulates investment advice given by companies operating in the UK financial websites located elsewhere may not be

subject to any regulation. In a chat room, don't forget that the person you're 'chatting' to is a complete stranger and could be anyone!

There have been cases of unscrupulous people using websites, bulletin boards, chat rooms and newsletters to 'talk up' companies in which they hold shares, in the hope of boosting the price. They then sell their shares and make a quick profit. This is known as *pumping and dumping*.

The reverse of pumping and dumping is *trashing and cashing*! False or misleading messages may be posted on Internet sites hinting that a company has financial problems. It may be completely unfounded but the rumour can result in the share price dropping. This allows the originators of the original trashing message to buy the shares cheaply knowing that the price will recover when the story is proved to be untrue. In one case, an individual was charged by police for allegedly publishing a false news statement, which is believed to have wiped £70 million off a company's value. The company's shares halved in value as a result.

The best way to avoid these problems is to use the Internet to *aid* your investment decisions not *rule them* entirely. Most importantly:

- Do your own *original* research. Look on the company's website. Get the Annual Report. Read the established financial press.

- Be aware that just *one person* can easily create the illusion of a highly successful company (or a failing one), simply by placing a large volume of messages on Internet chat sites, or mailing a few thousand e-mails at the touch of a button.

- Treat any invitation which claims to share 'privileged' information and urges you to act quickly to avoid missing out, with suspicion. Why would this person share their information with you?

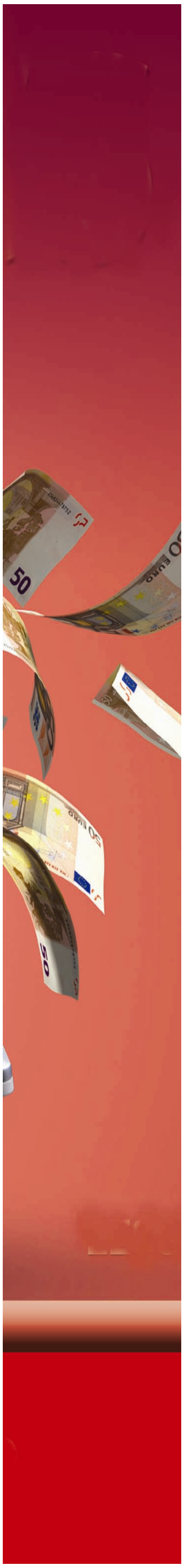
- Corroborate any information you come across on the Internet before acting. For example, if a source claims that a new product or new deal is imminent which will transform a company's fortunes, a few phone calls or e-mails can help you find out if this is true.

- Unscrupulous fraudsters can only influence share prices if people actually respond to their tipping!

Stock Market Terms Revealed

AIM: Alternative Investment Market. Less regulated version of the 'full' Stock Exchange mainly for smaller, newer companies.

Bid Price: Selling price of shares.



Consideration: Total amount of a share deal including cost of shares, fees and tax.

Contract Note: Confirmation of a trade showing shares traded and price paid or received. May be electronic.

CREST: Electronic settlement system for share transactions.

Cum-Dividend: When buying a share that is cum-dividend, you are entitled to receive the last dividend paid by the company.

EPIC: Exchange Price Information Code. Unique code identifying Stock Exchange listed companies. Also known as *symbol* or *ticker*.

Ex-Dividend: When buying a share that is ex-dividend then you are not entitled to the last dividend paid.

Flotation: The process used when a company is listed on the Stock Exchange for the first time.

Full List: Main market of the London Stock Exchange, as opposed to the AIM for example.

ISA: Tax efficient way of holding investments including shares.

Limit Price: Maximum price you are prepared to pay for shares (or sell at) when instructing a stockbroker.

Market Makers: People who ensure that there is a market in shares and who set the bid and offer prices.

Mid Price: A share price half way between the bid and offer prices and which is the price usually listed in newspapers.

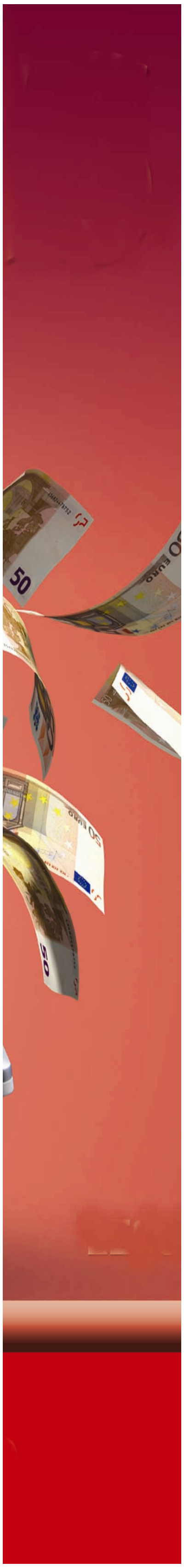
NASDAQ: National Association of Security Dealers Automated Quotations. A US stock exchange dominated by technology stocks such as Microsoft.

Nominee Account: Convenient way of holding shares, popular when using Internet stockbrokers.

OFEX: Stock exchange for smaller UK companies run by a broker rather than the London Stock Exchange. It can be very difficult to trade in OFEX shares and is more suitable for experienced traders.

Offer Price: Buying price of shares.

Pool: Holding of shares by a nominee.

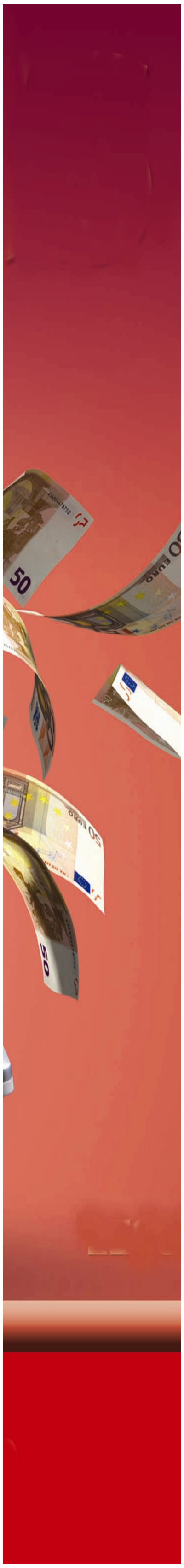


<u>Settlement:</u> Date at which shares are paid for, normally a fixed time after the transaction.

<u>Spread:</u> The difference between the bid price and the offer price. Normally, the bigger the company, the smaller the spread, the smaller the spread the better value you get.

<u>Stamp Duty:</u> Tax on share purchases.

<u>T+3, T+5 (Or Settlement Period):</u> The number of trading days between the date of your transaction and settlement. T+3 is the current standard.



Appendix of Websites: Lesson 5

Useful Investment Websites

Here is a selection of some websites you will find useful when investing in stocks and shares. This list is for information only and these sites are not endorsed in any way.

ADVFN
www.advfn.com
Site specialising in private investment and personal finance.

Association of Private Client Investment Managers and Stockbrokers(APCIMS).
www.apcims.co.uk
Details of stockbrokers.

AXL
www.axl.co.uk
Site with share price and financial information on UK companies.

Barclays Stockbrokers
www.stockbrokers.barclays.co.uk
Online stockbroker.

Cheapest Share Dealing UK
www.cheapest-share-dealing.co.uk
Comparison site to compare stockbroking charges.

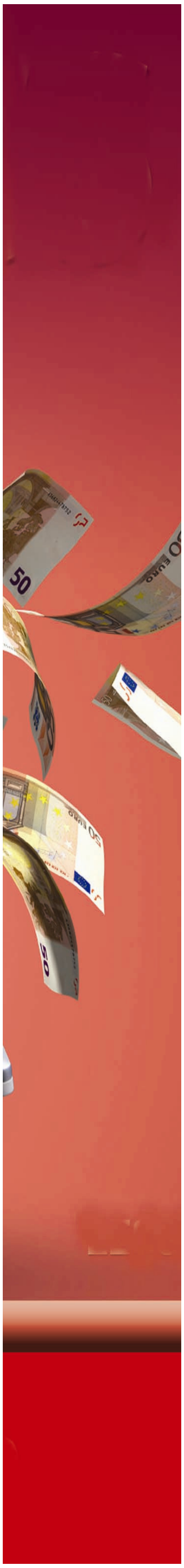
Citywire
www.citywire.co.uk
News and investment opinion site with coverage of collective investment and fund manager activities.

Comdirect
www.comdirect.co.uk
Online stockbroker.

CREST
www.euroclear.co.uk
The electronic settlement system for share dealings.

Daily/Sunday Telegraph
www.telegraph.co.uk
Financial news.

Digital Look
www.digitallook.com



Site featuring research summaries and news reports on UK companies.

Direct Sharedeal
www.directsharedeal.com
Online stockbroker.

E*Trade
www.uk.etrade.com
Online stockbroker.

Financial Times
www.ft.com
Online version of the financial newspaper with good links to other related sites, for private investors and small traders.

Financial Services Authority
www.fsa.gov.uk
Official site of the UK investment and finance regulator.

FT Cityline
www.ft.com/servicetools/ftmobile/cityline
Investment information service.

Halifax Share Dealing
www.halifax.co.uk/sharedealing
Online stockbroker.

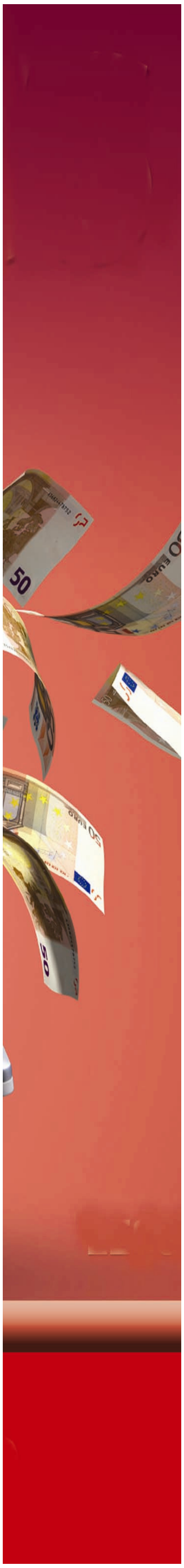
Hargreaves Lansdown
www.h-l.co.uk
Online stockbroker.

Hemscott
www.hemscott.com
Site specialising in private investment information, with emphasis on company information, news and opinion.

HSBC Stockbrokers
www.esharedealing.hsbc.co.uk
Online stockbroker.

Investors Chronicle
www.investorschronicle.co.uk
Official site of the weekly magazine.

James Brearley
www.jbrearley.co.uk



Online stockbroker.

London Stock Exchange
www.londonstockexchange.com
Official site of the London Stock Exchange.

MoneyAM
www.moneyam.com
MoneyAM is geared towards UK private investors and supplies a wealth of information along with live streaming prices, charts and in depth analysis tools as well as 'Shares Magazine' content online every week.

Money Observer
www.moneyobserver.com
Official site of the monthly magazine.

Moneywise
www.moneywise.co.uk
Official site of the monthly magazine.

Motley Fool
www.fool.co.uk
News and information on personal finance and investment presented in a unique, user-friendly 'Motley Fool' style.

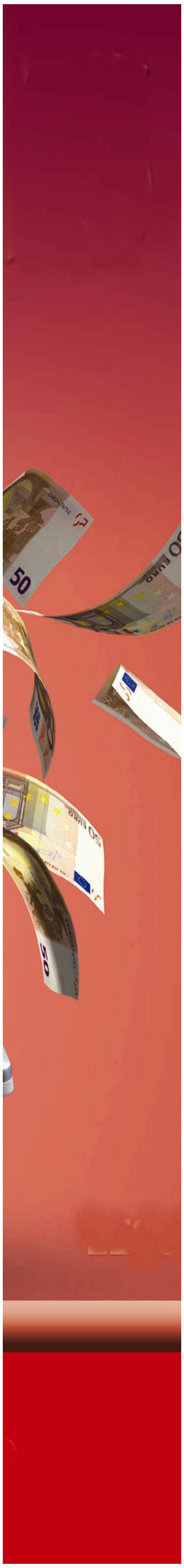
Mybroker
www.mybroker.com
Online stockbroker.

NatWest Stockbrokers
www.natweststockbrokers.com
Online stockbroker.

Norwich & Peterborough
Sharedealing Service
www.npss.co.uk
Online share dealing service.

Plus Markets Group
www.plusmarketsgroup.com

Personal Finance & Savings Magazine
www.themoneypages.com
Official site of the monthly magazine.



ProShare
www.proshareclubs.co.uk
Information for small investors and share clubs.

REFS Online
www.hemscott.com
Means to access the daily updated online version of the popular Company REFS analytical service.

Reuters
uk.reuters.com
Financial and business news service.

Selftrade
www.selftrade.co.uk
Online stockbroker.

Shares Magazine
www.sharesmagazine.com
see MoneyAM

Sharescope
www.sharescope.co.uk
Online technical analysis and portfolio management and accounting service/software for small traders.

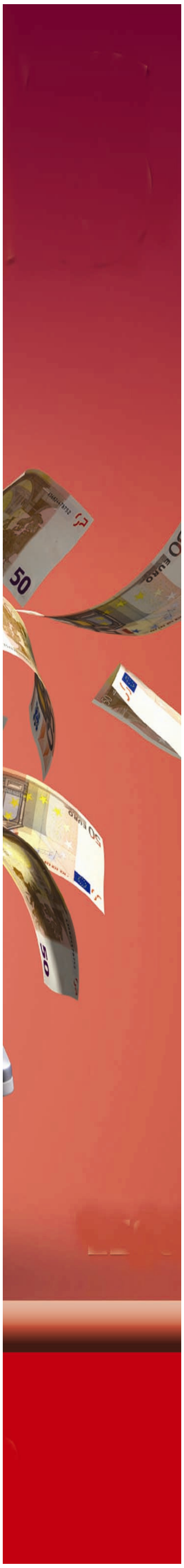
Stocktrade
www.stocktrade.co.uk
Online stockbroker.

TD Waterhouse
www.tdwaterhouse.co.uk
Online stockbroker.

The Guardian & The Observer
www.guardian.co.uk
Financial news.

The Independent
www.independent.co.uk
Financial news.

The Times/Sunday Times
www.timesonline.co.uk
Financial news.



This Is Money
www.thisismoney.co.uk
Official site of the monthly magazine.

Updata
www.updata.co.uk
Online technical analysis and portfolio management and accounting service/software for small traders.

What Investment
www.whatinvestment.co.uk
Official site of the monthly magazine.

Yahoo Finance
uk.finance.yahoo.com
Financial news and search service.

Please Note: Websites included in this appendix, or elsewhere within the course, are all operational at the time of writing and I do aim to check and update these listings on a regular basis. However, due to the nature of the Internet and the way in which websites can appear and disappear without notice it is always possible you may find some sites which have been renamed, moved or removed.