The Maverick Investor

LESSON EIGHT

by

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How to Make Lesser Known Investment Opportunities Work to Build Your Personal Nest Egg!

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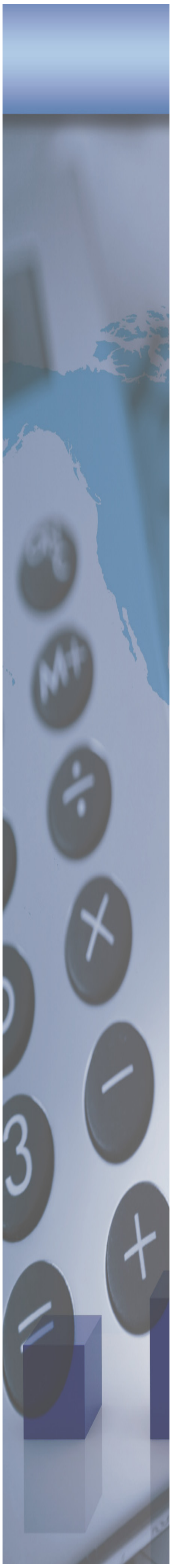
The Maverick Investor's Home Study Course

PART EIGHT

FUTURES, OPTIONS AND CORPORATE BONDS

CONTENTS

Page:



Hello and a big welcome back to the fascinating world of alternative investments.

Alternative investors who are looking for more speculative and exciting investments will have considered penny shares carefully. If these have whetted your appetite for more exciting investments, you will typically then want to think carefully about two or three other, often overlooked alternative investments - **futures, options and corporate bonds**. These are often considered together as they are three investments which can be bought and sold through a broker.

Here is what I will cover in this lesson:

- **Using Futures**
- **Investing In Options**
- **Buying Corporate Bonds**
- **Using a Broker**
- **Summary**
- **Further Reading**
- **Check Your Understanding**

Futures and options are really moving away from the edges of alternative investing, out towards gambling. They are akin to spread betting which we look at in part 10 of your course. In essence, you are predicting what a product, sector or market will be worth at some point in the future. Get it right, and you make a lot of money. Get it wrong, and you could lose a lot too! Corporate bonds are a less risky alternative, but are often no less exciting. **A good broker is essential if you are to invest - or gamble - wisely and well in any of these alternative investment areas!**

Using Futures

The theory of using futures as an alternative investment opportunity is a simple one, although profiting from them in practice is not always quite as straightforward. Here's the theory you need to know. All you do is commit today to either buying or selling something at a set price at a specified time in the future. That 'something' really can be just about anything that can be traded in the open market - it is typically a currency such as US dollars although it could equally be well be gold, diamonds, barrels of oil or bags of nuts!

For example, you commit to buy 100 ounces of gold in six months from now at a price you set at this moment (not six months time) – let's say $900 an ounce. Slightly more complicated, you commit to SELL 100 ounces of gold in six months from now at a price you set at this moment (not six months time).

Please don't worry at this stage about not having gold to sell, or taking delivery of large amounts of gold, dollars, pork bellies or whatever. **With futures, you NEVER (and I mean never) take delivery of the physical items you are trading.**

Clearly, you are investing on the basis you're reasonably confident that you know what is going to happen to the price of US dollars, gold or whatever in the near future. Say you commit to buying so many US dollars at such-and-such a price (set now) in six months from today's date. You've studied the market carefully for many months, taken advice and **are convinced the market price of US dollars then will be higher than the price you've agreed to pay**. If you are right, you can then (in six months time) *actually* buy at the agreed lower price, turn around, sell straight on to someone else (this is just a paper transaction, no dollars change hands) and pocket those profits.

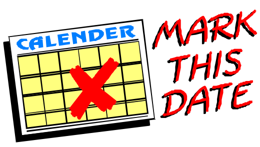
It sounds easy!

Or, as an alternative, let's say you have agreed to *sell* so-much gold at a particular price (say $800 an ounce) in perhaps three months from today. You don't own any such gold of course! If you were to honour your contract, you'd have to buy some gold in 3 months and then sell it immediately. Again, you've done your research, taken advice, paper traded and done all the pre-investment activities you've followed for every other alternative investment so far - and decided that the agreed selling price is higher than market price you predict at that time. Putting it another way, you're betting that the price of gold is going DOWN. If you are correct, you then in three months you buy gold at that lower price and immediately sell it to the person you contracted with at the higher price. Again, what could be easier?

Of course, there is a 'but' and it can be a big but. When it comes to both buying and selling, <u>the price could go against you</u>, and perhaps quite dramatically. If you are committed to buying so many US dollars six months from now, and when that time has elapsed, whoops, the dollar price has fallen (not gone up as you hoped) then to meet your obligations you must buy dollars at the agreed high rate and sell at the current low rate – you lose money.

I know a lot of people find this concept difficult so let me go into a bit more detail.

Futures Explained



As the name suggests, this is a market in the *future* price of a share or a commodity.

Let's pick a period of (say) three months in the future. What do you think might happen to ABC mining shares in three months from now? Ah, now that's not such an easy question to answer, is it? *Anything* could happen. There could be a major earthquake which destroys the mine (share price drops alarmingly), there could be an amazing breakthrough in mining technology which allows them to extract gold at half the price (share price rises modestly); they could discover vast new deposits of gold (share price rises dramatically) or a giant meteor containing 300,000,000 tons of gold could crash to earth (share price drops as gold is now almost worthless). You get the idea. With futures, there are many unknown factors which make your guess very uncertain - *but not totally random*.

Because it is *harder* to predict future prices, this makes it more of a gamble.

Looked at another way, if I were to ask you to predict the price of gold in one hundred years from now, ignoring inflation, you would dismiss this as pure speculation. No information you have now could have any bearing on this future price - everything is up for grabs, *anything* is possible. It becomes a wild guess; in other words, **a pure chance gamble**. Your guess is as good as mine, right? But if I were to ask you to predict the price of gold one hour from now (that's still a future prediction), you could guess it to within 1%. Gold rarely moves by 1% a *day* let alone an hour. Thus your 'futures prediction' has become *almost a certainty*, with no luck or chance involved at all!

So, the degree of pure gambling depends upon how far into the future you are guessing. The longer the period - the bigger the gamble. The shorter the period, the more of a certainty it is.

Futures markets are 'secondary' markets. The main market is in stocks, shares and commodities right now, this very minute. Futures markets can be **more volatile** than current markets. They can move up and down rapidly and even wildly, sometimes. This is the sort of thing which gamblers love!

In order to make big money, you need big movements. There is no money to be made in buying a blue chip like Tesco and hanging on to it. Not *real* money.

Gaming Companies

Playing the futures markets used to be difficult for the average person. You needed a stockbroker who knew you and trusted you. Also it is a full-time job watching the tiny changes in the futures price and guessing which way the market will go. This was a pastime for the idle rich. However, this has changed with the introduction of several gaming companies (sophisticated bookies) who will take bets from punters interested in the futures markets.

I will explain how this all works in a later module, but first let me explain why futures are so exciting in monetary terms, compared to normal stocks and shares. The reason is that **you do not have to hand over the full price of the future share, currency or commodity**, just a *small percentage*, say 10%. This makes it very exciting because the potential rewards are huge for a relatively small 'wager'. This is what gambling is all about. There is no fun in betting £1000 with the possibility of winning £25 plus your original £1000 back. Who cares? This is not worth getting out of bed for. But if you could win £10,000 for a wager of £500, then this is much more like it!

What Are Futures?

This is a market of people all *guessing* what the price of something such as a share, a commodity, a currency or an index will be in a few months from now. Because it is a *market* it needs two sorts of people, buyers *and* sellers. In this case, those guessing that the price will be HIGHER in, say, three months from now, and those guessing that the price will be LOWER in three months from now. There is no market unless *both types* of person are present and willing to trade. You need buyers *and* sellers to make a market.

If *most* people think the price will be HIGHER in the future, then the quoted futures price will be high. If *most* people think the price will be LOWER then the futures price will be low.

The price of the future sometimes bears no real relationship to the current price of the stock or commodity. This is an important point for you to realise.

One example is worth pages of waffle, so let’s look at *oil* - chosen randomly.

Let’s say the current price of oil is $85 a barrel. Let us also say it is January 1st. You are interested in the price of March crude oil - in other words, what price will oil be in three months from now? **God knows!** Your guess is as good as anyone else’s, but it is not a pure guess because many factors influence the price of oil. This allows you to take an ‘educated guess’. Trouble is brewing in the Middle East? You think a war is likely and this will cause oil prices to skyrocket. Your bet is that oil will be $100 or more a barrel come March. Everyone else knows about the trouble, of course, but quite a few reckon it will blow over - this has happened three times already. Also, they have their eyes firmly fixed on the latest North Sea and Antarctic discoveries which are about to be announced. *They* think that lots more oil will be found and that the price will be lower in three month's time.

Great!

We now have a *market* in this future. Buyers *and* sellers. In this example, you’re a buyer.

Here’s the good news, you don’t have to buy 1000 barrels of oil at $85 a barrel (= $85,000), store it in your shed and wait until March before selling it all at $100 a barrel! You can put up a small deposit (say $2 a barrel) to ‘reserve’ your barrels of oil for March delivery. Of course, you never take delivery of any oil, this is a paper exercise! If you like, you have reserved the *right* to buy 1000 barrels of oil, at $85 a barrel in March. Come March, if you were right and the price has gone up, you merely buy ‘your’ reserved oil for $85 a barrel and one microsecond later sell it for $100 a barrel and receive the profit ($15,000) plus your deposit back. If you were wrong and the price falls, you are not stuck with 1000 barrels of oil you didn’t want! No giant lorry will back up to your drive and start off-loading barrels! You merely **cancel your option** to buy the oil, saying, in effect, “I don’t want it after all, sell it to someone else” and you lose your stake (deposit) **plus the difference in price**

between the selling price and your future price.

For example, you bought March oil at $85 a barrel and guessed wrong. The price falls to $70 a barrel. You decide to bail out. To do this, all you need to do is pay the difference between $85 and $70 = $15. If you bought 1000 barrels, then this little trade will have cost you $15,000! Oops! That's going to hurt!

Of course, if you guessed right and oil does go up to $100, then you will have made $15,000.

Get the idea?

Selling Futures

We have just discussed an example of buying futures in a commodity such as oil. You can also *sell* futures. I found this a tricky concept when I first started out, and so I will try and explain it as simply as possible. You **have to understand this concept** before you can gamble on the futures markets, and many people struggle with this.

Prices can go two ways, up and down. I have explained what to do if you think oil (say) is going up, but what about if you think it is going down? You don't have to gamble only on rising markets - you can make money - actually a great deal of money - on falling markets too.

How do you achieve this?

Simple. You take an option to SELL oil in three month's time. Let's say the current price is $100 a barrel and the 3-month future price is $90. You think this is hogwash and the price is going to drop to $60 or less within three months. You *sell* March oil at $90. You pay the same deposit (say 10%) to secure 'your' oil sale as you paid to secure your oil purchase.

How on earth can you sell oil you don't have? Simple. Your sell order **guarantees a buyer of 'your' oil in March at $90 a barrel - in effect, someone has contracted to buy your oil at $90 a barrel in March. This is someone betting against you, buying March oil at $90/barrel, just like you did in the first example. Come March, they MUST buy your oil at $90/barrel, or pay you the difference between the March price and $90.**

If the price in March is only $60 a barrel, as you predicted, then you just buy oil at $60 a barrel (the current March price) and sell it to the guy who contracted, unwisely, to buy it from you at $90! You pocket the $30 difference! Of course, no oil ever changes hands. This is just a paper exercise. Also, oil is just one of hundreds of possible futures 'plays' you could make. There is nothing special about oil. I am just using this as an example.

Who is the 'mug' who contracted to buy from you at $90? Why, just another punter, *like you* but who thought the opposite to you. He thought the price was going to $120 and that YOU were the 'mug' for contracting to sell him March oil at 'just' $90 a barrel. He was looking forward to scamming you out of your oil at the give-away price of $90, and selling it immediately for $120 and pocketing the $30/barrel difference! He could have been right, of course. In which case, he would have won, you would have lost. In this event, you would have had to buy 1000 barrels at $120 and sell them at $90, thus losing $30,000!! Ouch!

Let's just clarify this with a further example which shows the money that's involved in these sorts of investments. You are mad-keen enthusiastic about widgets, have done all your homework, talked to widget collectors and advisors, and paper traded for six months to build know-how, practise and really get to grips with the widget market. You're absolutely sure that prices will rise dramatically within the next six months. So, you enter into a futures contract and commit to buying 5,000 of them in six months time.

The price at the moment is £15, you can contract to buy at £20 in six months and you think they will actually be worth £25 each in six months time. Fingers crossed, you will buy 5,000 at £20 a time, and then sell 5,000 on at £25 a time - and there's your profit – 5,000 x £5 = £25,000! Now this is where you need to be careful. If you have got it horribly wrong, you are still committed to purchasing 5,000 widgets at £20 a go. Say the market price falls - you goofed! - and is only £10, or maybe even £5 six months down the line. You are now looking at losses of perhaps £10 per widget - and 5,000 times!

Other need-to-know information about futures? Clearly, they are potentially high-reward, high-risk investments that are most suited to those alternative investors who know their market extremely well and who also can afford to lose money in a worst-case scenario. The pluses? They offer big money opportunities, and can also add some diversification to your portfolio. You might have a safe and steady property investment at one end of your portfolio and futures in diamonds at the other. The minuses? You could lose a lot, and you really need to have in-depth know-how and finances. What else? You can trade futures - you don't have to sit and watch those widgets plummet down to £5 a time or less.

Of course, this can be easier said than done - you've got to find someone who thinks these widgets will recover and rocket back up in price! Also, it's worth mentioning once again that you do not physically buy and sell US dollars, gold or widgets which you have to store in your back bedroom for six months or so. It is all done electronically by brokers nowadays. We'll come back to futures and brokers and other related matters in a moment, once we've looked at options so that you can see the differences between them.

Investing In Options

Options are in many respects similar to futures, although there is a key difference between them. As the name implies, these give you an *option* to buy or sell something at a particular price and at a particular time. With futures, you're committed (you *must* buy or sell). With options, you have a choice.

Let's say you have studied the penny shares market, and feel confident that you know it well. You have paper traded in the technology sector for months and have spotted a rising star - we'll call it Smith & Jones. Their shares trade at £1.00 at the moment. Now - as we know with shares, and especially penny shares - that could up to £2, £3, or £4 or down to 50p or 10p. It could go up, down, up and so on over the next few months. Shares, and especially penny shares, can be unpredictable.

Let's say you've done the usual research and think the share will rocket in the next three months. You can buy an option to purchase, say, 200 at a fixed price in that time - let's say you can get £1.50p, and you are sure it will go to £2.50, £3 or more. So you take the option (which involves you putting a little money down which you will lose if you do not take up the option eventually). If you're right, you take up the option, buy at £1.50 and can then sell on at a profit (say £2.50). If you are wrong, you don't take up the option and lose whatever it cost you to buy the option.

Alternatively, you might think the share price will fall dramatically - perhaps to 50p or even 10p! That's what your research is telling you. So you buy an option to sell a set number at an agreed price, say 80p. If the share goes down to 50p, you will then sell at the agreed higher price (80p) and pocket the difference (30p a share)! If the share goes the other way, you let your option lapse and so you lose whatever it cost you to buy that option, but not a whole lot more as you would with a futures contract. You've an escape clause!

Traded Options

There are, incidentally, also what are known as traded options - as with futures, you can sell these on to another investor if you can find one.

Traded options are essentially the same as options, or traditional options as they are sometimes called to differentiate between the two types. Traded options can be bought and sold on via a broker who deals in options. What they do is to deal in turn with various specialist options traders who will take these on. In essence, you can - if you change your mind about what might happen - bet for or against your original decision by selling on that traded option. Other key points about options? They are in many respects largely the same as futures, of course - but remember that the key difference is that you are committed with futures but have a choice with options.

What now if you are interested in the idea of either futures or options? As always you need to do your research, just as you've been doing for every other would-be investment. Whether you are going to focus on gold, diamonds or those bags of nuts, you need to build that know-how, talking to your advisers, reading your web sites, checking the financial press and so on.

For alternative investors, it may be a good idea to concentrate on futures and options that relate to something that you are keen on or have been investing in so far - property, penny shares, the various financial indices such as the FTSE 100 can all then be researched for both direct investments and for taking out futures and options.

Get to know your market inside out so that you can feel confident enough to predict what will happen in six months, one year, or whenever. Buying into property? What's going to happen to property prices in the next year? You should have a firm idea. Are shares for you? Which way are the indices going in the coming year? You should have some clear and definite thoughts on this. If you are sure you know the answers - and can afford to lose money if you are wrong - then you can invest in related futures and options!

Whatever you plan to invest in, always paper trade before you hand over your hard-earned money - and the longer you can paper trade, the better. You really don't want to be investing your money until your success rate is consistently high and you are making paper profits month-on-month, and overall.

What many first-time alternative investors do is to paper trade futures and options with a fantasy sum of £5,000, £10,000 or more. They make a game of it until they feel confident in themselves and their knowledge. Buy into five or 10 futures or options over, say, a six-month period and then monitor them for as long as you can to see how they perform. At the end of the period, you can see if you picked wisely (if not, why not) and how much money you made overall.

If you made a loss, at least you will have lost your fantasy money rather than your real money. If you can't see where you went wrong, **don't invest in futures or options.** If you can see where you made mistakes, have another go at paper trading for a further six months and, if you get it right this time, you can go on to invest from there.

A Word of Warning

Which brings me on to losses and the golden rule of gambling - all gambling.

The rule is: **Never, ever gamble with money which you cannot afford to comfortably lose.**

You've *heard* it a thousand times, now I'm asking you to BELIEVE IT.

During my years in the horse-racing scene I have witnessed dozens, perhaps hundreds of men (all men, I'm afraid - women have more sense!) lose *big* money which they could not afford. I'm talking about six months' rent money; this week's food money; the mortgage; the car payments, etc. I have also seen several men, one or two were good friends, **lose everything they owned** - house, car, wife and kids - due to gambling. Like all *bad* gamblers, they were betting unscientifically on 'hunches', 'feelings' and so on. They 'just knew' that this time their number would come up. **They even borrowed money to gamble** - the NUMBER ONE sin in gambling. They are *still* gambling with bits and pieces of borrowed money, and their social security cheque; hoping to "make it all back and more". This is a disease and if you think you have an addictive personality, **be careful about getting into gambling.** It can be very addictive, particularly if you win a few times. I'm not saying anything more than "watch out". Better people than you have succumbed to the evil of addictive and compulsive gambling - it can cost you everything.

The best guard against this is **a realistic view of life** - not a belief that there is a magical or mystical force at work, bringing you money. This is science, linked with randomness (called 'luck'). There are no mysterious forces at work here, and praying will not help your gambling one tiny bit!

It is worth stating at this point that you should not invest more than you can afford to lose in a worse-case scenario - those worse case scenarios can come true with futures! These investments in particular are not for cautious investors, nor are they for those who cannot afford to lose any or even write off all of their investment money. Bear in mind one example - you buy in and commit to purchasing 1,000 of whatever at £50 a time in six months. You're confident that the market price will be way higher then - easy money, or so it seems! But some terrible catastrophe strikes - a terrorist attack or war - and this has a roll-on effect, hitting the price.

Remember the impact that the 11th September tragedy had in all sorts of ways on airlines, travel, tourism and the like. The price falls to £40, then to £30 and you're panicking as you're now contemplating the full impact of this £20 drop and multiplying your losses by 1,000 a time. The price then keeps on falling to £20, and then to £10. Can you afford that £30,000 hit if it all goes sour? If not - don't invest! There is a big money upside with futures - but there is an equal downside to them.

Buying Corporate Bonds

Corporate bonds are different from futures and options - but we will look at them here as all three tend to be bought and sold via brokers, and we will talk about brokers next. So, some alternative investors mix bonds, and in particular corporate bonds, into their investment portfolio. At their simplest, bonds are very straightforward investments and are mostly rather more mainstream than alternative, although some offer great appeal to more speculative investors.

In essence, a bond involves you lending money to an organisation, which can be anything from the UK government through a start-up company to an overseas government. In exchange, you receive an IOU - also known as a bond! With most bonds, you will be given a set date when your money will be repaid. Each bond will also set out what else is involved - typically, you will receive fixed interest payments up to the point of repayment (or redemption as it's known), when you will normally receive your capital back, plus an additional interest payment, at least on occasions.

The reason why these investments are often considered alternative is that the organisation may be new, small, speculative, or based overseas. They offer potentially high-rewards - but high-risks too, of course!

Bonds come in various guises, and often have different names. Bonds issued by the government are known usually as **gilts** or **gilt-edged securities** as they are sure to be honoured by the government - in the UK at least! These are also sometimes called **treasury bonds**. Returns tend to be modest but risk is low.

Corporate bonds - or company bonds - are issued by companies wishing to raise cash and are potentially more rewarding and riskier, depending upon the company, its products and services, the sector, the market, and so on. It is these bonds that tend to appeal most to alternative investors. These bonds are often issued as a way of helping a company to expand, perhaps into new products, markets and so forth. Potentially, these can be classed as alternative investments.

Gilts can be categorised further in a variety of ways. They tend to be classed as being short, medium or long - depending on when they are due to mature and the money is scheduled to be repaid with interest. Short gilts run for up to five years. Medium gilts run from five to 15 years. Long gilts are for 15 years or more.

Some gilts are index-linked which means that both the interest payments and the final capital payback, perhaps with some interest, should be linked typically to the rate of inflation. Some gilts can be undated which means that they do not have a set redemption date and will continue to pay interest out on an indefinite basis. Generally, there is no guarantee that repayment will be made at any set time. Irredeemables are those without a redemption date. These need to be sold on to get that payback.

Corporate or company bonds can be categorised further and in two ways - as **debentures** or **loan stock**. Just like gilts, these bonds will typically come with a series of interest payments up to the point of repayment at a set date in the future. But there is a key difference between debentures and loan stock. Debentures are secured against the company's assets, loan stock is not - so you may want to think carefully before going down this route. You will want to be sure that the company is going to be successful, and should do the same sort of checks that you did when assessing penny shares.

Another type of company bond is known as a **convertible bond**. It offers you the chance to convert your investment into company shares - again, you will want to check for signs of success and so on before going down this route. This is where all of that penny shares research comes in useful.

So, what are the advantages of investing your money - or at least some of it - in bonds, and more specifically in corporate bonds? The big advantage is that bonds can slot into just about any investment portfolio, offering low-risk, low-reward investments for the mainstream investor or high-reward, high-risk investments for the alternative investor.

The beauty of bonds is that they can really be classed in two ways - gilts are generally considered to be mainstream investments sitting alongside of ISAs and some company bonds are widely regarded as alternative investments which can sit next to futures, options and so on. Put a gilt into your investment portfolio and you should get steady but unspectacular interest for the term, and a guaranteed payback at the end. Put a company bond - and especially one that's from a new, innovative, or fast-moving business - into your portfolio and you should have a potentially higher-reward investment, but one that comes with higher risks too.

As for the disadvantages, much depends on the bonds you're investing in. If you go for gilts, you have the benefit of low risks, but you also have low rewards too. If you go for company bonds, you have the big plus of potentially higher rewards, but the big minus that you may not get your money back at the end of the term. The business might fail and go into liquidation with a mass of debts!

As with all investments, you pay your money and you take your choice! For many alternative investors, corporate bonds are the main choice. The key question - how do you pick the right bond for you? Clearly, you will have some idea already of what you want to invest in. As you are a would-be alternative investor, you'll probably want to go for company bonds; higher-reward, higher-risk investments that will add a little spice to your portfolio along with penny shares, futures and options!

You can start your shortlisting process after you've done your research - reading the glossy magazines in the local newsagents, trawling your chosen web sites, talking to your advisers such as an IFA; all to build up your know-how about the current bonds that are available to you. Send for the literature, read it, especially the small print and so on. You can then decide which bonds suit your particular circumstances.

You know how much you have to invest, and what you might put into bonds, and when. You then need to see which bonds are available to you, allowing for the amounts and availability of the funds you're thinking of investing. Your first criterion for shortlisting is a practical one - deleting those bonds that want more than you wish to invest and/or before you wish to invest it.

It is sensible to think too about the reward-risk relationship, and what sort of bond you want to fit into your investment portfolio - again, this is another way of shortlisting easily.

As an alternative investor, you may be more interested in potentially higher-reward but higher-risk corporate bonds, although it may be wise to at least consider bringing in some gilts to add some steadiness to your portfolio. Much depends on what is in the portfolio already - most investors, including alternative investors, like to get a good mix, not just diversifying into different investments, but also diversifying by reward-risk so that they have everything in there from low reward-risk to high reward-risk.

Few investors want to have all their investments in the high reward-high-risk category, no matter how alternative and adventurous they are. A breadth of investments is generally wise - some steady performers to produce a solid return and some more exciting investments to add some fizz and higher returns, hopefully. You need to decide the reward-risk relationship that you want, and shortlist accordingly.

You then need to decide what you want from your bond, starting with any income you want or perhaps even *need* to receive from it, if you are looking for upcoming financial commitments to be met, such as school fees. Some bonds make regular but relatively low-ish payments each quarter or whenever, and then promise you'll get your capital back in full at the end, subject perhaps to various terms and conditions.

As an aside, always, always, always read those terms and conditions - and think how likely it is from your research that any worse case scenarios (such as the FTSE Index falling below a certain level) will actually happen. If they do, you might not get all, or in some cases even any, of your investment back. Some bonds are more generous with their interest payments on an ongoing basis but the trade-off (and there will always be a trade-off and you'll spot it in the small print) is that your capital investment is more at risk. You should look at what each bond is offering - regular interest payments, capital investment return, terms and conditions, likelihood of worst-case scenarios happening etc. - before shortlisting further.

Think too whether you want to hold your bonds through to redemption, or whether you might prefer to sell them prior to that. Much depends on your particular circumstances, of course. If you are investing in the short-term, you might not want your capital tied up for five years or more - and this can be another way of shortlisting. Those bonds that run for longer than you want to invest for can be deleted from your list straightaway!

Some bonds have to be held through to their redemption - you buy one at issue, receive the interest payments and all being well get your money back at the end. But gilts can be bought and sold via a broker and so too can some other bonds. You may wish to go for these if you want flexibility. Bond prices rise and fall. If you have a corporate bond in a company that's doing well, its price may rise - after all the loan is that much more likely to be repaid! You could sell on for a profit!

If you want to go down this investing route, you should spend some time researching and paper trading bonds and their prices before you go off and find a broker who'll do the investing for you. Paper trading will also help you to shortlist further and make that final choice. Get the Financial Times (or another up-to-date financial publication) and you can flick through and find charts containing the current bond prices. From left to right, you should see; the name of a bond; the coupon rate (in essence the interest rate); the redemption date (which is when the capital investment is due to be repaid).

Let's take a treasury bond, 14%, 200X (200x being one year on from whenever you are reading this course!)

All gilts are issue at £100 so £14 is being paid out each year and this gilt ends in 200X (i.e. this time next year) when it will pay back that £100 - a very nice return given the current climate of low interest rates!

The charts contain other key facts and figures too. You should see a price section which will give you the current price of the bond. That might be, say, £110 for this particular example. If you wanted to buy that bond now, it would cost you £110. You'd then receive £14 a year through to redemption. Note that you'll receive £14 a year for a £110 outlay, rather than £14 a year for a £100 outlay, so your interest rate in real terms is less than 14%. You should see an abbreviation, such as **Int** which stands for interest yield, and this gives you the exact figure to save you having to do a calculation. Note too that when the government makes repayment on redemption, it will be paying out the original £100, not the £110 that you will have paid. This needs to be taken into account too so that the actual rate of return for someone buying in can be calculated accurately. You should see an abbreviation, **Red**. This is the redemption yield and state the actual rate of return for someone who is buying in now at £110, taking interest payments through to redemption in a year's time, and is then receiving back the original £100. It's 5% - more realistic than the 14%, but still quite respectable in today's climate.

There is other useful information to be found in these charts. You should see a section headed **+/-** and this will show you how much the bond has risen or fallen from the previous day. The **High** and **Low** sections show you the highest and lowest prices of the bond over the past year, but check any accompanying notes just to confirm the period of time that is covered. These figures are useful for indicating how steady or volatile the bond is - and this can reflect all sorts of influences on it.

With corporate bonds, it may be the performance of the company in its marketplace - or any of the other factors that we have seen (from the preceding section on penny shares) that can impact on prices; results, rumours, product developments, and so on. As with other investment products that you'll buy via brokers, note the spread - the difference between the buying and selling prices which allows intermediaries to profit etc. In these charts, you will normally see the mid-price figure being quoted - the buying price will normally be slightly higher and the selling price will be slightly lower than this. Adjust your in-the-head calculations appropriately!

Timing

If you decide to buy into corporate bonds with a view to selling - in much the same way that you would do with penny shares - you need to think about the timing. Clearly you need to start by investing - as you do with penny shares - by going for those bonds that offer price-rising potential; in companies, sectors and markets etc. that look as though they are on the up. Successful alternative investors in these investments also work to various guidelines when it comes to selling. Generally, short-dated bonds will react to interest rate changes. If rates rise, bond prices often fall because you will get a better rate of return elsewhere. So some investors will sell prior to anticipated rises.

Short-dated bonds also tend to fall towards their issue price as they move close to redemption. The later you leave it, the less you'll get! Longer-dated bonds are influenced more by the general economy, inflation, and other factors regarding the company, the sector and the marketplace in question. Monitor what happens for a while though and you will see that price variations tend not to be too dramatic - these are steadier investments than shares!

Where Next?

You will probably want to start getting an armful of those glossy financial magazines from your newsagents, and start reading the Financial Times on a regular basis if you are not doing so already. If you want to look at gilts in more detail, go to your local post office - you can get plenty of literature, facts and figures and buy these there.

There is no minimum investment, although trading costs tend to make trades of less than about £1,000 fairly pointless - another selection criterion for you! You can buy gilts and other bonds via a broker. You would expect to pay about 0.75% on the first £2,500 and about 0.25% on anything above that. There is normally a minimum charge of about £20. For gilts, it is cheaper to buy via the post office than the broker. But, if you are trading in a changing market, bear in mind that this is a fairly slow system so you will not know what price you will be getting. There are no limits on the amount you can invest in gilts.

By the way, speaking of government investments, do consider Premium Bonds. I have held the maximum amount (£30.000.00) for over ten years and the return has averaged out at 5% - that's pretty good when you think I also have a shot at a million pound prize! They are risk-free as well.

Using a Broker

Buying futures, options and corporate bonds is much easier than many new alternative investors think - you simply go to a broker, quite possibly the same one that you might be using to invest in shares. To recap, to get a broker, you would typically be looking to invest about £1000 for an execution-only trade, upwards of £10,000 for advisory services and about £50,000 or so for discretionary services. These are broad-brush figures though and if you contact the Association of Private Client Investment Managers and Stockbrokers, as you will have done when you considered penny shares earlier, you may uncover brokers who will deal with investors with smaller sums to invest.

Choosing the right broker - whether it's for penny shares, futures, options, bonds or any other investments - really involves you asking three key questions, and then making your selection decision on the basis of their answers.

First, you must decide what services you actually want from a broker. Basically, a broker offers three main services to their clients. 'Execution only' services are exactly as the name suggests - you decide what you want to buy or sell, how much, when, and so on and then instruct the broker to do it. Even if they think you're wrong, they'll still do it!

The next level of service up is an 'advisory' service, whereby - for a higher fee - the broker will offer advice on what to buy and sell. This advisory service will include an execution service within it. A 'discretionary' service usually involves the broker taking charge of your investing, buying and selling shares on your behalf, within various guidelines that you may wish to lay down at the outset (e.g. your risk profile). This service is really for bigger investors. You might, for example, set various stop-loss figures on your investments, so that the broker will sell if or when the market moves against you.

It is really for you to decide which service is right for you - if you have built know-how and expertise, are paper trading successfully and are happy with the advice you are getting from other sources (financial press, web sites etc as examples), you may be happy with the execution-only style service. If you are not yet 100% sure of what you are doing - perhaps in practical, trading terms rather than an understanding of your chosen marketplace - you may prefer to go with the advisory services or possibly even the discretionary services, if you are investing larger sums.

Next, you will want to know what the services are going to cost you, so that you can budget these into your calculations and projections. There are two areas for comparison here, between brokers (although, of course, be aware that a broker who offers better advice can often justifiably charge more). There will often be a minimum trading charge, regardless of how much you are buying or selling. For penny shares, this might be £20 or so, or maybe more - it can vary significantly, so do shop around. If you are investing small amounts, you might find that constant buying and selling, with trading charges of perhaps £50 a time with some brokers, can easily eliminate much of your profits!

Check the commission that's being charged by the broker. This may typically be levied on a sliding percentage scale, based on the amounts involved. On an execution-only basis, you might pay 1% of the transaction value. Bear in mind that there will normally be a minimum fee involved. If you invest larger sums, you may find that the percentage will be slightly less if you invest more.

If you go for advisory services option, you might pay 1.5% on your transactions. Again, this percentage may be lower as you invest more. Perhaps the first £5,000 of transactions might be charged for at 1.5%, with any amounts above that incurring a 0.5% charge. Again, do double-check on the minimum fee involved, which might be £20, £25 or so. For discretionary services, you would normally expect to pay an annual fee based upon the sums that the broker is investing for you. The fee will typically be about 0.75%. Check on what else will be charged in such a situation.

Never assume that these are the full range of charges - ask to check if there are any others. If you are investing overseas, you might expect to pay higher charges, as an example. You must always take account of these costs in your investing decisions. Generally, the higher your costs, the less you will have left in profits.

Of course, much comes down to the quality of the advice you are being given - if you are getting better advice and investing more successfully, you would expect to pay a slightly higher commission for it. As with everything else, you get what you pay for in most instances. You may want to go for the cheapest when it comes to execution-only services, assuming that the cheapest does the trade correctly! When it comes to offering advice, the better brokers tend to charge accordingly.

The third key question then tends to be how much confidence you have in the broker. If you are using a broker on an advisory or a discretionary basis, you will want to feel that their advice and guidance are sound and that they are trustworthy, particularly if you are entrusting large amounts of money to them. You might raise questions such as: Which is your regulatory body? What qualifications do you have? What specialist qualifications do you have? What are your main areas of expertise? What ongoing services do you offer? It is worth considering these sorts of questions carefully, and in a little more detail at this point.

“Which is your regulatory body?” In the UK, an investment intermediary will normally be registered with the Personal Investment Authority (PIA) or the Securities and Futures Authority Limited (SFA). The broker should provide membership and contact details and you can then call for confirmation. If they deal overseas, you must ask for the name and contact details of the regulatory body there.

You should then approach these bodies for promotional literature on what they do, members' responsibilities, the standards and codes of conduct they must adhere to, and what happens if anything goes wrong. You should find these regulatory bodies are helpful. Obviously, if the body is unhelpful and you seem to have little or even no protection, you would be wise to look elsewhere.

“What areas do you specialise in?” All brokers specialise to a certain degree, whether they are in the UK or overseas. The easiest way to see if they have the expertise in the areas you are focusing on is to ask this general question. If you say something along the lines of “Do you offer advice on futures and options in diamonds“, you'll find that some will “yes” whether they have that area of expertise or not!

It's also worth checking out both their general and their specialist qualifications; these will normally be listed on business cards, letterheads, web sites and the like. You can check UK qualifications out with the regulatory body in this country. You should do the same with regulatory bodies overseas' as appropriate. Ideally, these qualifications will have been obtained by detailed study and examination.

“What other services do you provide?” You may know what you want to invest in and just want to do a straightforward deal through them. If you are sure you know what you are doing, that's all you need to do. Generally though, you will find it helpful to have some sort of ongoing feedback from them whether that is in the form of general advice (such as market trends) or more specialist advice (when to trade). Increasing numbers of brokers provide this via newsletters, web sites and e-mail services.

Incidentally, it is worth asking for back issues of newsletters and looking at archives of web sites to see if the earlier advice that was given seems sound with the benefit of hindsight (and, if certain issues or pages are missing, do wonder why)!

"What investments do you recommend?" A key question! You should expect any bona-fide broker to tell you why they are recommending a particular investment opportunity to you. Make sure you understand and agree with what they are saying - do their comments, for example, tally with what you have already uncovered yourself from your research, reading of the financial press, and conversations with other advisers.

Dig a little deeper to find out about the investment, especially if you have not heard of or considered it before. Too many investors just look at the likely returns. What are the terms and conditions of withdrawing early, for example? The intermediary will tell you about the rewards. Do they also spell out the risks? A bona-fide one will.

Most successful alternative investors will say that you should pick a broker by personal recommendation - it's by far the safest way to uncover the right one for you. But if you are going for advisory or discretionary services, do double-check that the family member or friend who is making the recommendation is broadly similar to you in terms of their personal and financial circumstances, and in particular their investment portfolio and goals.

Say they are married with a young family - they may only have a little extra money to invest and only in safe and steady investments, such as gilts. If you are newly retired with some spare cash and want to have some speculative fun, you may be looking for something a little more exciting such as futures and options. The broker who is excellent at tipping safe and steady gilts may not be quite as hot when it comes to recommending futures and options in gold, diamonds and exotic items.

For the majority of alternative investors, execution-only services are all that's needed to invest successfully in many of these investments - there is plenty of investment advice available from all sorts of different sources so you've no real need to pay extra. And, as a final tip, you'll often be able to get some free-of-charge recommendations from execution-only brokers anyway. Generally, you'll buy and sell over the telephone or by e-mail these days and will be dealing with any one of various brokers within a particular firm.

The trick is to spot someone who seems friendly towards you, and a little chattier than the others. In future, ask for this person by name so that you start building a one-on-one relationship with them. You'll then discover as time passes that they are more likely to give you snippets of advice if you ask them questions. For example, if one of your bonds suddenly rises in price for no apparent reason, your contact may reveal what's considered to be the cause within the industry. You'll also find that your broker's computer screen contains lots of technical data that may be useful to you. Ask, and the broker may tell you, especially if you are a regular trader. Bottom line? They won't want to risk losing your custom!

Summary

1. **Futures** are an increasingly popular way of profiting from alternative investments. They involve committing to buying or selling a set number of (usually) goods at a specific price at a set time, perhaps six months down the line. It is important to note that this is a commitment, not an option! These offer potentially large rewards, depending on what happens to the price between then and now. These are high-reward, high-risk and are most suited to experienced investors who can afford to lose significant sums in worse-case scenarios.

2. **Options** are similar to futures in many respects but tend to be lower-risk. With an option, you agree to buy or sell a set number of (normally) goods at a particular price and at a set time, perhaps in three, six or 12 months. The key is that this is an option not a commitment. If you then change your mind, you simply lose whatever it cost you to take out that option (typically a few percent of what the deal would cost if it went through), thus you can still obtain potential rewards but can avoid what might be almost unlimited losses that could be incurred in a futures contract.

3. **Bonds** come in all shapes and sizes! Gilts are issued by governments and tend to be relatively low-risk, low-reward in nature. They may fit in well and provide some diversification in an otherwise high-reward, high-risk investment portfolio. Corporate bonds are issued by companies, and these can be more speculative by nature - it depends on the company, what it is doing, and what its activities are. These tend to be higher-reward, higher-risk investments and are most often favoured by alternative investors.

4. Futures, options and corporate bonds will normally be bought and sold via a **broker**. Brokers usually offer three types of services - execution-only services, advisory services and discretionary services. It is sensible to shop around as services vary, as do the costs involved and the expertise of those brokers involved. Most alternative investors tend to use execution-only services. If you go for advisory or discretionary services, you should expect to pay a little more for those brokers who offer better advice!

Further Reading

Options, Futures and Other Derivatives by John Hull (0130091448, Prentice Hall)

Trading Systems and Methods by Perry J. Kaufman (0471148792, John Wiley and Sons)

Point and Figure Charting: The Essential Application for Forecasting and Tracking Market Prices by Thomas J. Dorsey (0471412929, John Wiley and Sons)

Come Into My Trading Room: A Complete Guide to Trading by Alexander Elder (0471225347, John Wiley and Sons)

Market Wizards: Interviews with Top Traders by Jack D. Schwager (0887300101, Harper Business)

Investment Psychology Explained: Classic Strategies to Beat the Markets by Martin J. Pring (0471133000, John Wiley and Sons)

Understand Bonds & Gilts in a Day by Ian Bruce (1873668724, Take That)

Pricing Money: A Beginner's Guide to Money, Bonds, Futures and Swaps by J.D.A. Wiseman (0471487007, John Wiley and Sons)

Check Your Understanding

Before moving on to study the ninth part of your course (on investing overseas), please stop for a minute or two and read through the following questions which cover what you have just been reading. You should answer these before going any further. If you can answer these all correctly, you will know you are ready to move on to the next part of the course. If you are not sure of a particular answer, you can of course refer back to the appropriate section to check it!

Using Futures

1. What is a futures contract?

2. How do you profit from a futures contract when it comes to buying?

3. How do you profit from a futures contract when it comes to selling?

4. What are the risks involved with futures contracts?

5. Are you happy with these potentially high-reward but high-risk investment opportunities?

6. Do you know you could lose an almost unlimited amount of money?

Investing In Options

1. What are options?

2. What are the similarities between futures and options?

3. What is the key difference between futures and options?

4. How can you cut the risks of losing money on options?

5. What are traded options?

6. Which are safer; futures or options, and why?

Buying Corporate Bonds

1. What are bonds?

2. What is the main difference between a gilt and a corporate bond?

3. What are irredeemable?

4. What is the difference between debentures and loan stock?

5. What are the advantages of investing in bonds?

6. And the main disadvantages?

7. What is the redemption yield?

8. What is meant by the phrase the spread?

9. Where can you buy gilts?

10. Where can you usually buy corporate bonds?

Using a Broker

1. What is usually the best way to find a broker you can use for investing?

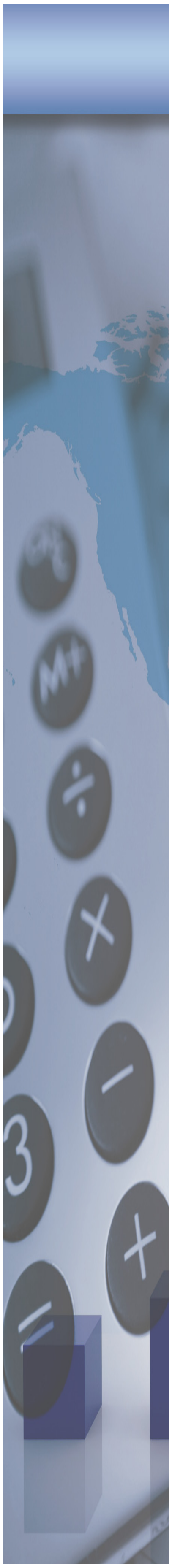
2. What are execution-only services?

3. What would you normally expect to pay?

4. What are advisory services?

5. What would you usually expect to pay for these services?

6. What are discretionary services?



7. What would you typically expect to pay for discretionary services?

8. Why is it important to shop around when choosing a broker?

9. What are your key areas of concern?

10. What questions should you be asking a broker you're thinking of using?

Have you checked the summary for this section?

Have you made a note to read the books listed in the Further Reading section?

Have you answered all of these questions?

Yes? You're now ready to move on to part nine and find out how to invest successfully overseas!