Inside Money: Trade Secrets

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THIS IS A TRANSCRIPT OF THE LONGER REPEATED VERSION

CURWEN: The subject of the Inside Money programme you are about to hear is investing in shares. It was recorded three weeks ago before steep falls began in share prices across the globe. We'll hear more about those later on. But first, here's the original programme which deals with eternal issues surrounding the risks and rewards offered by stock markets.

HORSE RACING SOUNDS…

CURWEN: Meet Radio 4 listener Sandy Clarke. She works part-time as an occupational therapist and she likes to go to the horse races in her spare time.

CLARKE: I didn't win on that race. But I came third and at the end of the day if you cover your expenses more or less then I'm very happy.

CURWEN: She loves the excitement of backing a horse….

CLARKE: The way I pick a winner - sometimes I get what I can only describe as an Irish feel. I will just get a sense that this horse is going to be lucky on the day.

CURWEN: Sandy may have her own instinct for picking winners, but now she has a bigger decision to make, than which horse to bet on. Sandy is 60 and lives on her own in West London. She used to work for the NHS and has just started taking her pension. That gives her a regular income and a lump sum of £50,000. She still works part-time, and has no plans to stop in the near future. She already has some cash savings set aside for a rainy day, a small mortgage of £10,000, and no other debts. But she’s not sure what to do with the £50,000 lying in the bank.

CLARKE: I’ve been sitting on this money for a few months not knowing what to do about it and I have got to do something about it. I make quick decisions on other aspects like betting on a horse but when it comes to a lump sum, I’m very, very nervous as to what to do about it and who to approach. I would very much like to know more about shares and how do you decide what shares might be worth looking at.

CURWEN: Sandy would not be getting a list of recommendations of individual shares she might buy. What Inside Money could show her, would be general principles of investing. Returns on shares may have been tempting over the last couple of years. But there've been real wobbles on world stock markets this summer, due to worries about increasing interest rates, and shrinking amounts of money available for companies and consumers to borrow. The London stock market this year had been close to levels it reached in the year 2000 – at that point technology shares had soared, but that was just before the market fell into a three-year slump. Some experts suggest the time is now ripe for another downturn. David Jones, Chief Market Analyst at CMC Markets, is someone who studies closely the trends and cycles of markets' behaviour. Sandy asked him if he thinks they are at a turning-point.

JONES: That is the question I think and it's very interesting where we are with global stock markets at the moment. Looking at it from a sentiment point of view, one way of looking at it is well, seven years ago, slightly more than seven years ago, this is where investors decided stocks are overvalued and it's time to sell and we saw the market drop by 50% over the next three years. So the big question at the moment on everyone's lips is are we going to see the same thing happen again? It's a tricky one to call.

CLARKE: What makes the market go up and down?

JONES: The quick answer, and it's not really a flippant answer, it's more buying than selling. What's makes markets move is the actions of investors, whether they're investors with £500 to invest or whether they're a fund manager with £10 million to put in the market. Markets move as a result of fear and greed. Over the past four plus years we've seen greed in the market where the market's risen. So people have kept on buying. When it comes to selling, people have wanted maybe higher prices than they wanted two months ago for their shares, and when we saw the market slide from the year 2000 to the year 2003, it was fear that gripped the market, the market dropped 50% and people would see some quite drastic plunges in share prices and it was really panic selling that was driving the market lower. From a technical analysis point of view, again from the way I tend to look at markets, a chartist point of view, it really is market psychology and then human fear and greed that drives these markets.

CLARKE: Is this a good time to invest?

JONES: I think the one way of looking at it is if you have a long-term horizon, let's say ten years plus, then arguably there's never a bad time to invest in the market because historically stock markets have outperformed other asset classes over the long-term. There's always an exception to this, however. If we look back at the Japanese market in the early 1990s, if you'd invested, let's say a thousand pounds in a Japanese market back then, 17 years later your thousand pounds is still probably only worth around about £500-£600. The important thing to understand with financial markets is there are no guarantees. If you want absolutely no risk, you have to park your money in a building society account.

CURWEN: In fact, rates on savings accounts have been looking increasingly attractive. Was Sandy open to taking a risk in the hope she'd get even better returns?

CLARKE: It's been very, very interesting hearing about crashes and the highs and lows of shares and how different things can affect the markets. But I think history tells us with pretty careful planning that you have a pretty good chance of keeping your money and possibly keeping up with inflation and making a bit more.

CURWEN: According to one authoritative survey by the investment bank Barclays, over the last ten years, shares would have given you double the returns of keeping your money in the bank. But as David Jones had warned, there are no guarantees. Sandy needed advice, about how to spread the risk, by putting some of her money into other key investment areas, such as government bonds, or gilts, which offer a fixed rate of return. And it wasn't just about investing – she had to think about her finances as a whole too. Remember Sandy still had a small mortgage of £10,000. She met Justin Urquhart-Stewart, of 7 Investment Management.

CLARKE: Justin, can I start by asking you are there any golden rules about investing?

URQUHART-STEWART: I like clearing the decks and getting all the debt out of the way. Debt is an awful albatross round your neck and with interest rates going up the chances are that debt's costing you more as well. So I always try and pay down debt first.

CLARKE: If I pay my mortgage off, then I will have about £40,000 to play with. How best would you see me investing that?

URQUHART-STEWART: One of the most important rules for investing is asset allocation - having a broad range of different things you can invest in. Unfortunately our industry has a nasty habit of actually focusing on the ones that they can actually make money out of. That tends to be shares. Think about a range of different things you can invest in. Let's assume you want to keep your capital fairly safe but have some growth as well. On that sort of basis you'd probably have about 50 per cent in shares. Broadly invested shares around the world and that may not necessarily be directly you may be using some funds - and all a fund is where you're effectively buying an investment manager running a fund for you, investing your money and you own a unit of it a part of that particular fund. But of course in doing so you're actually paying an extra cost there because there's the cost of actually running that fund. Then a certain amount in fixed interest as well to make sure you've got that area covered so some gilts or even corporate bonds but of course cash. There's nothing wrong with cash. It's a perfectly good asset class. So you've got a blend right the way through. Why do you do that? For that simple reason you want a table to have several legs to it. If you've actually got a table with one leg and the leg falls off, you ain't got a table; but if one or two are a bit wobbly for a time, then that's okay.

CURWEN: Is it a good time for Sandy to start investing in shares?

URQUHART-STEWART: No one ever knows whether it's a good time or not. What you have to do is just invest on a regular basis because it averages out over time. However, with £40,000 what you don't want to do is to be buying separate things the entire time, incurring too much commission, so you might have to do it in slightly larger lumps, so maybe lumps of £10,000 at a time over the next few months or years. There's no rush, the market will always be there, and so what you're doing is merely averaging it out over that period.

CLARKE: If I invest in shares directly, do I need to use a stockbroker?

URQUHART-STEWART: Yes, if you want to buy shares, you'd normally go through a stockbroker. Stockbrokers will vary in their types. You've got ones which are known as (rather threateningly) 'execution only'. That merely means that they can buy and sell shares, act on your request - so you ask them to buy Shell, they do it. Then you've got advisory stockbrokers who will actually say, "Well I think you should be buying Shell" or whatever company it happens to be. And then you've got discretionary brokers and those ones will take your money under your guidance and they will actually invest it for you according to what you actually require. But they're the ones then making the decisions. There are some of the trading houses you can go to as well if you want to do day trading, but that can be pretty risky and I would suggest that's only for someone with some considerable experience and quite a lot of them don't make money either.

CLARKE: Is betting on shares the same as betting on horses?

URQUHART-STEWART: They're both bets, betting on horses and betting on shares. One is an investment where you expect a return, the other is a bit of fun. As far as I'm concerned, you can bet on just about anything: you invest in a process and a structure and a discipline. I often tell clients that you separate your money out. By all means have some betting money and if you want to have a punt on a share, that's okay, but by far and away the majority of it should be run in a very disciplined way with broad asset allocation. So I think we have to be very careful – have a blend according to the risks that you want to have, and the risk is very easy to measure: how much do you feel you could afford to lose?

CLARKE: Well with this particular sum I'm prepared to take a bit of a risk and I would like to see it grow, I really would.

CURWEN: Sandy had been told how she might divide up her money among various classes of investment, including shares. But she still didn't know how she would go about choosing which sort of shares to buy. We would take her to meet two professional investors to see how they do it. First, Sandy met Alpesh Patel, author and one of Britain's best-known online traders, who's been investing in the stock market since he was a teenager.

OFFICE SOUNDS…

CLARKE: Could you tell me, what all these screens are?

PATEL: Like many investment managers we have a multitude of screens. I mean I'm actually conservative, I've only got three, but there are some who'll have about twelve. And it allows me to look at various things that are happening in the market simultaneously (…fades)

CURWEN: Sandy wanted to learn more about Alpesh Patel's buccaneering individual approach to investing.

CLARKE: How do you know what to invest in?

PATEL: Well actually I have some very strict rules and the key criteria that I have are first of all the stock has to be a value stock. Now what I mean by a value stock is a stock which given its share price and whatever that share price is, it's throwing up a lot of profits. In other words, it's a cheap company in rough and ready terms. Now that's the nub of valuation - am I picking it up cheap for the profits that it's generating? The second thing I'm looking for is it a growth company? By growth company, I mean does it year on year for the past three years generate increasing sales because if it's generating increasing sales, the company must be doing something right, the management must be doing something right and they must have a good product, and those are the important things in any successful business. So that's growth. The third thing is income. Is it generating dividends? Is it generating profits for me as a shareholder by paying me back not just in terms of capital gains as the share price moves, but also giving me a dividend so that I'm getting not just capital gains but also income as well. And that acts as a safety net in case the share price goes down. At least I got some dividends out of it - maybe 5, 6% a year.

CLARKE: How do you know when the right time to invest is?

PATEL: It's a very good question. Funnily enough, in an odd way it's the wrong question and I'll explain why. Everybody asks is it a good time to invest in the market? Well actually the right question is what are the best stocks to own which will protect me against falls in the market, but if the market does rise I'll be able to outperform the market? Because, of course, we're not talking about whether we want to put no money in the market. We'll always want to be invested in the stock market if there's some good opportunities and even in a falling market there's always good opportunities. And the reason for that is that even in a falling market people will invest in quality companies. It's not as if people take all their money out of the stock market totally and completely. So given that the question is where are the good stocks, which are the stocks that we ought to be buying which will protect against falls should the market fall and will give us good rises … and that way also I'm not trying to predict the direction of the broader market, that's not what I'm trying to do. I don't want to try and outsmart the rest of the world; I'm not clever enough to do that. What I want to do is pick some good quality companies. So in a way that question of yours is answered by the fact that I pick value, growth and income companies because those in bad times should still give me safety and generate fairly good returns and in good times should generate outstanding returns. One of the mistakes private investors make is they want to do the one impossible thing in the markets. They want to make a lot of money with very little risk in the shortest possible time. Those three things combined are impossible, sadly. I mean they're about as likely as winning the lottery. You've got to give up on one or two or all three of them a little bit.

CURWEN: We had to put it to Alpesh Patel - isn't it a dangerous exercise investing directly in individual shares? If a company does unexpectedly badly, you could lose a lot of your stake. He explained his strategy for reducing the risk.

PATEL: I think you probably want a portfolio, a stock portfolio of about fourteen stocks. There's a lot of academic research to show that fourteen stocks, as long as they're not all in the same sector, they're not all oil stocks or telecom stocks will give you a good spread of risk versus reward and you make sure that you will exit any of those individual stocks if they drop let's say 25%, whereas the mistake private investors make is they own five companies and they'll hold any one of them if they drop even down 90%. So if we avoid those little things – in other words what we call risk and money management - then mathematically it'll be very difficult for you to lose the kinds of big sums private investors tend to lose.

CLARKE: Can I go it alone without any advice?

PATEL: If I was being really mean, I'd say that the advisers aren't that good anyway and you probably should go it alone because … you probably can out-perform the advisers by just following some very simple principles like looking for value stocks, growth stocks, income stocks, and there's a lot of free websites out there. However, many private investors - they like to have a bit of advice, you know a bit of handholding, and if you find a good stockbroker … and a good stockbroker, they'd hate me for saying this, is like a good plumber - it's going to be word of mouth, you know. Have they fixed somebody else's plumbing really well and has it stood the test of time? So you probably do want a bit of handholding initially just in case you make some blaring errors.

CURWEN: Sandy was fascinated to hear Alpesh Patel's views on the pitfalls of some private investors. As a complete novice, she realised she couldn't go it alone – she would want expert help and advice.

CLARKE: Alpesh's input has been mind-boggling and lots to think about. But obviously I would need very, very good advice and perhaps ongoing advice as to what shares that I would hold and advice about when to pull them out.

CURWEN: Many private investors are not prepared to do what Alpesh Patel does – buy individual shares directly. They're more likely to buy into shares through a pooled investment fund, with lots of shares in it. There are thousands of funds to choose from. Some invest in certain regions of the world, or certain industries, such as biotechnology or mining. Of course, it costs you more to buy the expertise of the managers who are choosing these shares on your behalf. Often there can be an initial fee of anything up to 5 per cent, plus annual charges of 1 and half per cent. So how do fund managers decide which shares to buy? Sandy was lucky – the second professional investor she would meet, is one of Britain's most successful fund managers.

BOLTON: I'm Anthony Bolton from Fidelity. Very nice to meet you…

CLARKE: I'm very pleased to meet you too.

CURWEN: Anthony Bolton is investment director at Fidelity International – he's famous for running the Fidelity Special Situations Fund, which has given investors average growth rates of 20 per cent a year, across the last 28 years. That means an investment of a thousand pounds made in 1979 would be worth around a hundred and fifty thousand pounds today.

CLARKE: What can I get through a fund that I can't get through investing in shares myself?

BOLTON: A fund is really just a collection of shares. You get access to an investment manager to manage those shares. If you're an individual who follows the stock market closely, you could put together a collection of shares yourself and you'd probably need to have at least a dozen or maybe twenty to get a diversification, so you're not too much exposed to one share. But what I think we can add, you know, we spend every day looking at companies, looking at economies, looking at stock markets and trying to decide which are the best shares to invest in and avoid the worst shares. And for an individual, they can do some of that; but maybe they don't have all the resources that we have to do that.

CLARKE: How would you yourself decide which shares to pick?

BOLTON: Right. I mean that's quite a complex question to answer, how I pick shares. And the first thing is to say I have a team here to help me, so you know so you know I'm one of thirty fund managers running investments here and then I have a team of analysts to help me, about seventy analysts who are making recommendations based on their knowledge normally of industry - so somebody follows banks shares, somebody follows supermarkets, etcetera, etcetera. A prime input into the process is meeting the companies we're going to invest in. I normally meet two companies a day. So the managements will come in and they'll talk about their business and we'll cross examine them and I keep notes and this is my … I've got here my 51^{st} book of notes that I've taken over the years and so they've got all my notes including the meeting I had this morning with a company. So part of our meeting with companies is meeting the people and I like managers who don't promise you sort of, you know, the lights and then don't deliver. I like managers who promise you a bit and then next time we see them they've given you what they said that they were going to and they're consistent. And then I want to understand the company - how does the company make money? We do a lot of analysis on what we call the financials, so we do models of how the companies' profits are going to be in the future. Then … my sort of style, which is … tends to be going against the herd and going against the trend - I'm looking for companies often that other investors don't like, so they're under owned by the majority of investors. And then finally I like to look at is there the possibility that this company will be involved in mergers and acquisitions it might be a target to be bought by another company? And it's a combination of all these factors. And sorry, it's a long answer, but it is a complicated question. It's a combination of all those that go into my process whether I buy the shares of a company or not.

CURWEN: It sounded impressive. But how much would an investor have to pay for this sort of service? The standard charge for Anthony Bolton's fund at Fidelity is 3 and a half per cent in initial charges and then 1 and a half per cent annually each year. Some brokers may be able to reduce that cost. But it may still be expensive compared to say, a simple tracker fund, also known as an index fund. This automatically tracks the performance of a whole stock market index, such as the FTSE-100 in London. Anthony Bolton acknowledged that can sometimes be a cheaper option for investors like Sandy.

BOLTON: It's a difficult area because if you pick say a fund with a pin, on average, the average fund manager does worse than, say, an index fund, so you would be paying that extra expense. Index funds have expenses, but they're generally much less. They're, you know, .1%, .2% per annum instead of 1½%, so that's a considerable difference. But if you pick a good manager, that can be far outweighed by performance. Now the fund I run, I've run for about, coming up for twenty-eight years. It's averaged a 20% return over that period, so I think you know, and that's after deducting the fee, so I think the fee has well been worth paying in my fund. Now that's not – it hasn't produced that every year -there's been the volatility that you get investing in the stock market. So it comes back to, that if you can pick a good manager and find the right organisation and a manager and look at their track record, then I think that will very much outweigh the fees.

CLARKE: Do you think it's a good time to buy shares now?

BOLTON: I've been in this business thirty-five years and I think one of the most difficult things of all is predicting where the market is going in the short-term. These are my personal views and they're not Fidelity views. If you're taking a three to five year view, then I think stocks and shares are an excellent place to invest your money. All that said, just at the moment we've had four years of strong markets and a lot of shares have done extremely well. I think investors are not differentiating between some shares that are more risky than other shares and that makes me somewhat cautious about stock markets in the short-term and I'm talking about looking ahead six months or so. So that would be my short-term view.

CURWEN: You just heard a bit of a warning there, a personal note from Anthony Bolton about the next six months. What do you think about that?

CLARKE: I think I would take that advice very, very seriously and review what I would be doing.

BOLTON: Coming back, you know, what I'm really saying is, I think we could be in for a more choppy period, put it that way, and, therefore, I think to be on the sidelines that you might get an opportunity over the next few months - maybe you have to wait a bit longer than I'm saying. Maybe it's twelve months or whatever – but I do think an opportunity where that cash that you've got on the sideline, you may get a really good opportunity to come back into the stock market through a fund of one sort or another during that time.

CLARKE: What's your best bit of advice for somebody who's thinking about investing at the moment?

BOLTON: I think if you're going to invest, you've got to know yourself because it's very easy to be shaken out of the stock market in bad times and the worst time to sell is when the news is the worst, if you see what I mean. So when you feel uncomfortable and when you're thinking to yourself oh gosh, you know maybe things don't look so good and maybe the stock market investment thing isn't the right thing, that's normally when markets are low and that's when a lot of investors get shaken out because they haven't got the staying power. I think a bit of the other is also true - try not to be sucked in after a huge rise when everyone else is in there. Now if you're somebody who gets sort of frightened quite easily and you don't have the temperament, then maybe the stock market isn't for you so I think that's an important aspect.

CURWEN: Anthony Bolton of Fidelity speaking the day before the stock market began falling back in July. That's almost where this programme should have ended but since Sandy Clarke finished recording those interviews for Inside Money we've seen increasing turmoil on world Stock Markets especially over the past few days. Some experts now pose the question after four years of rising share prices, are we moving into the next cycle of falling prices? Well, Anthony Bolton had implied that Sandy might need nerves of steel if she does start investing in shares. His personal and prescient advice for her had been to exercise caution over the next six months or more. I asked Sandy what her original conclusions were three weeks ago about what she'd do with her lump sum of £50,000.

CLARKE: I had decided to get rid of my mortgage and pay it off partly because of possible rising interest rates but also in order to have a clean sheet really with my investments. I also had decided that I would invest a little of the money in safe stocks and shares and by that I mean some of the bigger companies that have very, very good reputations and aren't going to sort of disappear overnight. But I was going to postpone that for six to nine months on the back of what Anthony Bolton was saying and really take a very slow approach.

CURWEN: Given what's happened to the stock market since you've finished doing the interviews, have you changed your mind?

CLARKE: Not really. I'm still not frightened about shares. I think if shares go down in value, some of those shares might be very, very good value and I would look for advice – in fact, I intend to look for advice to enquire about what I should invest in. And, whatever people say, I'm not going to part with my cash easily.

CURWEN: So for you it's not a question of if you invest in the stock market, it's just a question of when?

CLARKE: It is a question of when and I will be very, very cautious about when I put my money in. I've learnt a lot those three days and I have learnt that it's better to be cautious than too positive and too hasty about buying shares.

CURWEN: But you are still very positive about it?

CLARKE: I am. I think, of course there's bad news every now and again but overall I think shares are a reasonable risk to take with one's money - certainly better than keeping it under the mattress.