LEARN TO INVEST SUCCESSFULLY AND BECOME RICH

Do you find yourself working very hard but not creating enough wealth to live the lifestyle you want or to even save for a comfortable retirement? You are going to learn how ordinary people, even those with no prior investing experience, can truly build a multi-million dollar net worth and regular passive income with the right investment strategies.

However, we live in an economic era when making money is no longer as easy as investing in good stocks and mutual funds and watching them appreciate over time. Today's volatile and interconnected financial system means that the stocks you own can come crashing down today and climb even higher tomorrow due to developments in Europe and the Middle East.

Yet, investing in the stock market still provides one of the best returns for your savings and the only way through which an average income earner can hope to become financially free. This is why it is important for you to become a savvy investor who knows how to achieve consistent profits — even in an uncertain global economy.

In this book, you are going to learn to...

- Invest in Winning Stocks That Generate High Double-Digit Returns
- Identify Market Uptrends and Downtrends Accurately
- Hedge and Protect Your Portfolio from Market Crashes
- Short Sell and Profit in a Down-trending Market
- Manage Your Risks and Maximize Your Returns
- Develop the Psychology of a Disciplined Investor
- Build a Winning Portfolio That Suits Your Investment Goals
- Build a Passive Income Stream from Real Estate Investment Trusts
- Build a Multi-Million Dollar Net Worth on an Average Income

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WINNING THE GAME OF STOCKS! ADAM KHOO

ADAM KHOO LEARNING TECHNOLOGIES GROUP

WINNING
THE GAME OF STOCKS!

How to Get Rich Investing in Stocks

ADAM KHOO

#1 NATIONAL BEST-SELLING AUTHOR OF *WINNING THE GAME OF LIFE!*

WINNING
THE GAME OF STOCKS!

How to Get Rich Investing in Stocks

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About Adam Khoo

Adam Khoo is an entrepreneur, best-selling author and peak performance specialist. A self-made millionaire by the age of 26, he currently owns and runs multiple businesses with a combined annual turnover of $30 million. His business interests include advertising, fund management, conference management, pre-school education, corporate training and learning centres. He is the Executive Chairman of Adam Khoo Learning Technologies Group Pte Ltd, one of Asia's largest training & education companies. He is also a professional investor and investment advisor for the Wealth Academy FX Growth Fund.

Adam has authored 12 best-selling books spanning the topics of academic mastery, personal development, parenting, finance and entrepreneurship. These titles have been consistently placed on the national best-sellers list and been translated into six foreign languages.

Adam holds an honors degree in business administration from the National University of Singapore. As an undergraduate, he was ranked among the top one percent of academic achievers and was a pioneer in the university's Talent Development Program. In 2008, he was conferred the NUS Business School Eminent Alumni Award for being one of Singapore's most prominent business leaders.

Over the past two decades, he has trained over 500,000 students, teachers, professionals, investors and business owners to achieve excellence in their various fields of endeavor, by imparting them his vast knowledge and highly actionable success strategies.

His success story and achievements are regularly featured in regional media like The Straits Times, The Business Times, The New Paper, Lianhe Zaobao, Channel News Asia, Channel U, Channel 8, NewsRadio 93.8FM, The Hindu, Malaysia Sun, The Star and even on Brazilian national TV. In 2007, Adam was ranked among the 25 richest Singaporeans under the age of 40 by The Executive magazine.

A life enthusiast with an unceasing passion for helping others, he believes that every person deserves to succeed in life. Today, he continues to inspire thousands of people around the world by sharing his success strategies and financial management techniques on his personal website and blog. You too can connect with him on www.adam-khoo.com.

About the Illustrator: TEO AIK CHER

Teo Aik Cher is an educator whose words and illustrations have been featured in numerous publications. He has illustrated for Adam Khoo's best-selling book *Secrets of Millionaire Investors*; the Speak Good English booklet *Speak Well, Be Understood;* illustrated and wrote for the first and second Singapore Kindness Movement books. He is also the best-selling author/ illustrator of the *Why?* series of books that include *Why Procrastinate?*, *Why Study Smart?* and many others.

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Also by Adam Khoo

I Am Gifted, So Are You!

How to Multiply Your Child's Intelligence

Clueless in Starting a Business

Master Your Mind, Design Your Destiny

Secrets of Self-Made Millionaires

Secrets of Millionaire Investors

Secrets of Building Multi-Million Dollar Businesses

Nurturing the Winner & Genius in Your Child

Secrets of Successful Teens

Profit from the Panic

Profit from the Asian Recovery

Winning the Game of Life!

Dedicated to the Memory Of

My Maternal Grandfather
Lau Kheng Yong (1912 – 2012)
The Greatest Investor and Most Generous Man
I Have Ever Known

&

My Paternal Grandmother
Molly Khoo (1919 – 2013)
The Kindest and Most Intelligent Woman
I Have Been So Fortunate to Be Raised By

A Big *Thank-You* to All Those Who Have Shaped & Touched My Life

To my parents, Vince, Betty and Joanne, who have given me unconditional love and support through the years. To my wife, Sally, who is my pillar of inspiration and strength. To my two daughters, Kelly and Samantha, who make me smile every day.

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To my YPO forum mates, Vincent Ong, Deborah Ho, Beh Swan Gin, Hogi Hyun, Ramesh Subrahmanian, Adelena Shee, Maarten Buitelaar, Heinrich Jessen and Antoine Firmenich. To my friends, Joey Yap, Ong Tze Boon, Aaron Ang, Elim Chew, Goh Kai Kui, Ismail Gafoor, Dennis Wee and Patrick Liew. This book is also dedicated to the hundreds of coaches who have volunteered their time to continually come back and coach for the *I Am Gifted!™*, *Patterns of Excellence™* and *Wealth Academy™* programs. Especially to WAIIC committee members in Singapore, Malaysia and Indonesia. We could not have done it without you!

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Introduction

How to Really Make Money from Stocks

"Do I buy and hold or do I cut my losses when stock markets plunge?"
"Can I really time the market or is it just wishful thinking?"
"Is it worth listening to recommendations by investment experts?"
"How do I know if a stock has the potential to rise over time?
"Why does a stock fall in price even when the company does well?"

Nobody can blame investors for being thoroughly confused nowadays at what to do with their investments. It seems that every time you read the news, you get contradictory advice and opinions from even the experts.

Many 'how to invest' books and seminars confuse people even further as they preach very different investment strategies. Some educators teach you to buy cheap stocks and hold them for the long term. They advocate buying more stocks and averaging down should the price start to fall even more.

Other experts expound the "buy high and sell even higher" approach of momentum trend trading. They advocate cutting losses once the price falls to a certain level and to sell for quick profits if the price continues to run up.

Many people I talk to find that no matter what approach they adopt, they never seem to be able to make consistent profits from their investments. They may score a nice profit once in a while, only to find themselves losing it all back to the market eventually. Even when they invest their money with professionally-managed funds, they find their investments going nowhere or worse, struggling to breakeven. In their frustration, many of these people resign themselves to earning a meager 1% – 3% in interest from bank deposits.

Is There a Way to Really Win the Stock Market Game?

The fact is that there are people who make huge amounts of money from the markets, year after year. These are the professional and semi-professional investors/traders who are able to grow their investments anywhere from 15% to 150% annually.

While these successful investors do have losing investments (everybody does), the fact is that over time, they consistently make much more than what they lose from the inevitable mistakes they make. So, how do they do what they do? What really works in the market and what doesn't? How much of it is luck? Can these skills be learned by anyone?

This topic is something I have passionately studied and practiced for over 21 years, ever since I started investing with my mother's stock brokerage account at the age of 18 years old. I am not only proud to say that I have made a nice fortune as a semi-professional investor, but I am even more proud to say that I have made every conceivable mistake that can be made in the world of investing. It is the mistakes I have made in the past as well as my ability to continually fine-tune my strategy that has allowed me to discover the profitable investing techniques that I employ today.

This book is the result of the 21 years of investing knowledge and experience I have accumulated — taught to you in a practical and easy-to-understand way. This book will dispel the myths of investing and reveal to you the answers you have been seeking. The strategies in this book will keep you away from risky stocks and show you how to invest in great companies that continue to grow and strengthen over time. The trend following techniques you will learn would have prevented you from getting hit by the US subprime mortgage crisis of 2008 – 2009 and shown you exactly when to get back into the market when global stocks doubled from 2009 to 2012.

These Successful Investing Techniques Can Be Learned by Anyone!

The great news is that these winning investment techniques can be learned and applied successfully by anyone, regardless of your past experience and background. Through my *Wealth Academy™* investing program, I have had the privilege of training investment analysts, financial advisors, bankers, as well as individuals like engineers, teachers, homemakers and students who started with zero financial knowledge.

Here are some of the experiences my students had after learning these strategies…

Grew Investment from $10,000 to $18,000 in 1.5 Years

Recouped All Losses with an Additional 35% Return

Increased My Portfolio by 30% in Just over 4 Months

$300,000 + Profits from Oct 2008-Aug 2009
75% Return in 11 Months

Recovered Losses of More than $50,000 and Holding on to Good Gains

What Does It Take to Become a Successful Investor?

In this book, you are going to learn the three key principles of successful investing: *Method, Money* and *Mind*. Profitable investing begins with having a winning *method* that will give you an edge over the market. While no method can guarantee a profit 100% of the time, I will show you winning methods that ensure that your investments succeed majority of the time.

You are going to learn a set of rules that will tell you exactly WHAT stocks to buy, WHEN to buy and WHEN to sell. You will learn that knowing WHEN to buy and sell a stock is even more important than knowing just WHAT to buy. Many people end up buying the right stock but at the wrong time. As a result, they watch the stock decline further downward in disbelief. You are going to learn how to read the emotions of the market and enter only at the time when the stock is ready to make explosive gains upward.

You are also going to learn the second 'M' of successful investing — *money* management. Many investors with a good investing strategy may still end up losing money because of poor risk and money management principles. They may make money from nine great investments only to lose all their profits in one bad one. You are going to learn how to minimize your risks and maximize your returns through portfolio management and position sizing techniques. You will learn how many shares you can afford to buy of each stock and when to cut your losses when an investment goes bad.

Finally, you are going to learn how to master your *mind*. You are going to learn how to adopt the winning psychology of successful investors and manage negative emotions like fear and greed that get in the way of your success.

I am sure you will find this book extremely useful in helping you become a more successful investor. I look forward to sharing my ideas with you in the pages to follow!

CHAPTER ONE

How Ordinary People Build Extraordinary Wealth

How Ordinary People Build Extraordinary Wealth

CHAPTER**ONE**

We live in a time of unprecedented abundance and opportunities. With a click of the mouse, we are able to access an unlimited source of knowledge on a myriad of ways we can create wealth. With the power of the Internet, anybody can start and create a business from home and reach out to a worldwide customer base. With interconnected financial markets and online brokers, anybody can buy shares in companies and real estate assets from anywhere in the world, within seconds.

Today, it does not matter if you are 20 or 65 years old, Asian or Caucasian, born to a rich, well-educated family or to an impoverished one. Despite your background, you have all the resources within you and around you to create the extraordinary level of wealth that you desire and deserve.

I know so many people (many of them my close friends) who have become millionaires many times over before the age of 35. One of my university classmates, Yeo Keong Hee, decided to quit his job as an analyst with the Government Investment Corporation of Singapore (GIC) to become a full-time trader. Within three years, he turned a $100,000 starting capital into $1,498,000. He is now managing a portfolio in excess of $5 million.

I also have friends who started late but built their wealth all the same. Conrad Alvin Lim, aged 42 years, was declared a bankrupt after his media business failed during the 2001 recession.

Despite being close to a million dollars in debt, he turned his financial situation around, got discharged from bankruptcy and became a millionaire again within a span of six years. He achieved all this by learning how to trade successfully in the financial markets.

What separates these wealth creators from so many others who struggle financially is that they have taken responsibility for their own financial destiny. They have chosen not to blame or depend on the government, their bosses, friends or families to help them make a living. Instead, they have chosen to model the strategies of the rich, learned the required financial skills and put in the necessary amount of hard work to make their dreams a reality.

There Has Never Been a Better Time to Become a Millionaire than Today

Indeed, we live in a time when the number of millionaires is growing at a pace faster than any time in human history. Moreover, the greatest growth in wealth is coming from the Asian continent.

In 2011, the number of millionaire households in Singapore rose by 14 percent to 188,000. In the same year, that in China climbed 16 percent to 1.43 million, while that in India saw a 21 percent increase to 162,000, according to a 2012 report from The Boston Consulting Group.

Taking a look at Table 1.1, you can see that in countries like Singapore (the country where I reside), a stunning 17.1% of the population is made up of millionaires — the highest percentage in the world for any country.

Table 1.1: Proportion of Millionaire* Households by Country (2011)[1]

Ranking	Country	Proportion of millionaire householdsinpopulation(%)
1	Singapore	17.1
2	Qatar	14.3
3	Kuwait	11.8
4	Switzerland	9.5
5	Hong Kong	8.8
6	United Arab Emirates	5.0
7	United States	4.3

**'Millionaire' is defined as having more than US$1 million in investable assets, excluding owner-occupied property.*

So, there has never been a better time to become a millionaire than today. It has never been easier to become a millionaire than today. If so many people can do it, there is no reason to say you cannot do the same.

But… Not Everyone Is Getting Richer

While the number of millionaires in the world is increasing at a faster pace, the unfortunate fact is that the disparity between the haves and the have-nots is also increasing rapidly. While the rich are getting richer, the poor are also getting poorer. At the same time, the middle class, who used to be living comfortably in the 1980s –1990s are finding it increasingly difficult to get by with the income they earn. While there are increasingly more Ferraris on the road, there are also increasingly more people who are finding it hard to make ends meet with the soaring cost of living. Something must be done to stop this increasing financial disparity in the world. It is sad when 80 percent of a country's wealth is concentrated in the hands of the top 10 percent of its population.

[1] Jorge Becerra et al., "Global Wealth 2012: The Battle to Regain Strength", BCG Report, May 2012

Why the Rich Are Getting Richer and the Poor Are Getting Poorer

What is causing this widening income gap? The answer is the disparity in the level of financial education. In the past, all you had to do was to get a good job, work hard, do as you are told and wait to be rewarded with salary increments and bonuses. In the old days, companies took care of you financially for life. In the past, you didn't need to be financially savvy to be assured of a healthy nest egg. All you had to do was to depend on your company to look after you and leave your money to expert money managers and financial advisors.

In today's interconnected world of rapid globalization, it is a whole new ball game. Only those who are financially savvy will have the opportunity to get richer, while the financially unlearned will only get poorer, no matter how hard they work and how much they save. Gone are the days when we can blindly entrust our money to bankers and financial advisors. Just listen to the horror stories of people who have lost their life savings to AAA-rated Lehman Brothers bonds back in 2008.

Having a good education, getting a good job and working hard can no longer guarantee you financial success. This is simply because salaries can no longer keep pace with inflation. With small apartments costing over $1 million, vehicle certificates going at $100,000 and weeklong family vacations costing $10,000, wages are barely enough to cover the bills. Nowadays, a middle class family with a household income of $10,000 per month finds themselves being barely able to save enough to ever retire. To their dismay, many realize that they have to work all the way to their grave.

To have any hope of building wealth today, you must have the financial intelligence to build multiple streams of passive income by investing in the right assets. You must have the financial know-how to grow your savings at a rate much faster than inflation. Only those who have a high level of financial education will be able to see and capitalize on the tremendous opportunities that are present today.

This is the reason why I started my *Wealth Academy™* range of financial education programs over eight years ago. One of my missions is to empower people from all walks of life with the financial knowledge that is so essential to building and sustaining wealth today. I truly believe that everyone can and deserves to be financially successful. All they need is the right financial tools and strategies and most importantly, the right mindset.

Choose to Be Financially Successful — Do Not Leave It to Chance!

The first thing to understand is that financial success does not happen by chance but by choice! It is the choices you make that determine where you end up financially. The great thing is that the choices you make are completely within your control.

You can be born in a poor family with no financial role models and even be deprived of a college education. However, if you choose to make the right financial decisions, you can end up extremely wealthy and break the cycle of poverty in your family. A 2007 report by Forbes[2] revealed that almost two-thirds of the world's 946 billionaires made their fortunes from scratch, relying on grit and determination, and not their inheritance. Fifty of these self-made tycoons were college or high school dropouts. Asia's richest man, Li Ka-shing dropped out of school at age 15, after his father died, to work in a factory. One of the world's wealthiest women, J.K. Rowling, was on welfare raising her little girl when she was struggling to write her iconic Harry Potter book series.

[2] Tatiana Serafin, "Rags to Riches Billionaires", *Forbes*, June 26, 2007, http://www.forbes.com/2007/06/22/billionaires-gates-winfrey-biz-cz_ts_0626rags2riches.html.

At the same time, you can be born into a family where you are given all the love, support, education and opportunities. However, if you make the wrong financial choices, you can easily blow everything you have and end up broke. I am sure you have read about countless examples of people in these two different situations.

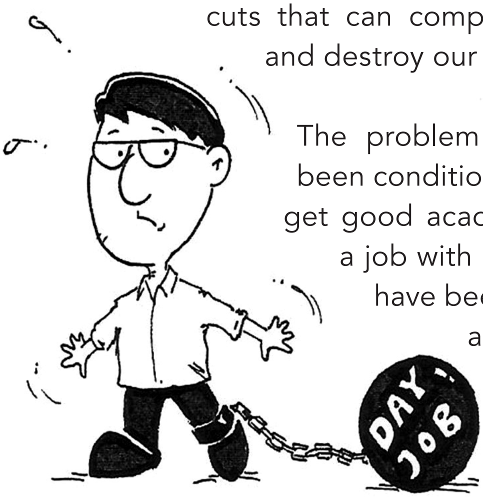
So, stop blaming or depending on your boss, your family background, your level of education or your age in your pursuit of a better life. Instead, start focusing on how you can develop better financial skills and make better financial decisions. For example, do you choose to depend solely on your job for income or do you choose to constantly find ways to invest in assets that generate multiple sources of income? Do you choose to spend more than you invest or invest more than you spend? These are some of the most critical decisions that will affect your financial destiny. Let's look at the difference.

Choosing Active Income — Employment

Active income is income that you earn by selling your time for money. It comes in the form of salary, wages and fees that we get from holding on to a job. The vast majority of people focus the majority of their time on earning their money this way.

If the majority of your income comes from active sources, then it is going to be very difficult for you to be freed from the rat race. The challenge with active income is that there is a limit to how much you can earn. This is because there is a limit to how much of your time you can sell.

By being constrained to just a single source of income from your job, you will not be able to scale up your wealth by very much. At the same time, depending on a job as a main income source gets more risky as you get older. Gone are the days when we can depend on our employers to take care of us for the rest of our lives. The moment we move past 40 – 50 years of age, we become very vulnerable to retrenchments and pay cuts that can compromise our living standards and destroy our financial future.



The problem is that most people have been conditioned by society to study hard, get good academic qualifications and find a job with a good salary package. They have been brought up to believe that as long as they work hard and follow the rules, they will be financially secure. The reality today is that many hardworking professionals find themselves not having enough left over for retirement after paying their escalating expenses. As a result, they struggle financially and find themselves stuck in the rat race for life.

Choosing Passive Income — Financial Assets

The rich play the game very differently. They realize that to get ahead financially, they have to focus more on building sources of passive income. They know that the key to wealth is having the majority of their income come from their assets and not their job.

Passive income is income that you earn from owning income-producing assets. To become wealthy, you have to start focusing more and more of your time on creating and buying these assets. The three main income-producing assets are 1) businesses, 2) real estate and 3) intellectual assets.

If you study the richest people in the world, you will find that the vast amount of their fortune did not come from having a big paycheck. Rather, their wealth came from their ownership of businesses, real estate and intellectual assets. In fact, many billionaires don't even bother to take much of a salary. The late Steve Jobs (former CEO of Apple), Larry Page (CEO of Google) and Vikram Pandit (former CEO of Citigroup) have all taken only a $1 annual salary from their company. It was the shares they held in their respective companies that generated their multi-million dollar fortunes.

When you start to focus on building passive income from creating and investing in the most profitable assets, you will find that your wealth is no longer constrained by how much time you have. Unlike only being able to hold one job, you will find that you can own multiple businesses and multiple properties, thereby creating multiple streams of income that keep growing at an exponential rate.

Asset #1: Own Successful Businesses
You Can Buy the Most Successful Companies with the Click of a Mouse

The first income-producing assets that you need to focus on owning are businesses. Start to change your mindset from that of an employee to that of being the owner of businesses. As the owner of a profitable business, you get a share of its profits in the form of dividends. As the business grows, your ownership in the business becomes more and more valuable as well.

You can own businesses by starting a company from scratch and building it yourself or you can simply learn how to buy very successful companies. When I tell people that they can go out and buy a highly profitable business tomorrow, they look at me with a blank stare.

What many people do not realize is that the stock market is actually a supermarket of companies. It is a place where businesses are on sale. Anyone can buy shares of the most successful companies in the world. With a few thousand dollars, you can buy shares of Coca-Cola, Nike, Visa and Google, making you the part-owner of these great businesses.

The best companies to buy are those that sell a product or service that you yourself use regularly. For example, have you bought an Apple product in the last 12 months (e.g. iPhone, iPad, MacBook, iTunes apps)? Well, every time you spend money buying these gadgets, you are contributing to the sales and profits of Apple Inc. So, who owns this wonderful company? Shareholders own the company! By opening an online stock brokerage account, you can buy as many Apple shares as you want with the click of a mouse! Within minutes, you can become one of the many shareholders of Apple. So, how well would you have done as Apple's shareholder over the last 20 years?

Take a look at Apple's share price chart. If you had invested $10,000 in Apple shares in 1983, your ownership would be worth $4.28 million today (as of June 2012).

Chart 1.2: Apple Share Price Chart 1980 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

Here's another example. Have you eaten at McDonald's at least once in the last 2 months? I believe it is highly likely. Again, every time you visit McDonald's and order a meal, you are making this restaurant giant more profitable. If you had been one of the many shareholders of this company, you would also have done very well for yourself.

Take a look at McDonald's share price chart. If you had invested $10,000 in McDonald's shares in 1980, your investment (including dividends received) would be worth $1.47 million today (as of June 2012).

Chart 1.3: McDonald's Share Price Chart 1980 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

When I showed these facts during one of my presentations, a member of the audience commented, "I have been working for McDonald's for the last 8 years and I have not even been paid that much!" Indeed, shareholders of a company will always make more money than the employees working in the company. The best part about being a shareholder is that you do not have to turn up for work. All you have to do is to watch your wealth grow and receive your share of the profits once a quarter. So, it is always more profitable to be an owner than an employee.

As you can see, the stock market allows you to buy and own successful businesses without the risk and hassle of starting your own. You can be an employee and yet enjoy the benefits of being the owner of several successful publicly listed companies.

Of course, not all companies are worth buying. If you invest in lousy companies that are losing money, then obviously you won't receive any dividends and the value of your shares will fall. In this book, I am going to teach you how to invest in only the most financially stable and profitable companies that will grow your wealth over time.

Asset #2: Own Valuable Real Estate

You Don't Need to Have Hundreds of Thousands of Dollars to Start Buying Real Estate

Besides owning businesses, you also have to start learning how to build a portfolio of valuable real estate that will generate regular rental income for you. Real estate prices in densely populated and land-scarce locations will always increase over time, thereby increasing your wealth along with it.

Imagine being able to own a portfolio of properties (apartments, shopping malls, office buildings, etc.) in the best locations in countries like Singapore, Hong Kong, the United States and China.

Many people believe that they need hundreds of thousands or millions of dollars to play the property game. What many people do not know is that they can actually start to own pieces of valuable real estate, starting with a few hundred or thousand dollars. The way to go about doing this is by investing through real estate investment trusts (REITs).

REITs allow you to invest in real estate assets like office buildings, shopping malls, hotels and apartments, starting with as little as $600 – $800. These REITs pool millions of dollars from thousands of small investors and use this money to invest in a portfolio of real estate assets. The REIT manager will then manage the properties, collect the rental income and distribute 90% of the income back to you and the rest of the other shareholders.

In Chapter 7, you are going to learn how to invest in only the most stable and profitable real estate assets through REITs.

You will learn how to build regular passive income for yourself without the hassle of taking huge mortgage loans, managing tenants and maintaining the properties yourself.

Asset #3: Own Intellectual Assets
You Can Collect Royalties for Your Own Creations

As the name suggests, intellectual assets refer to "mental products" created from your original ideas, which can be copyrighted, trademarked or patented. Some examples are articles, books, songs, films, artworks, photographs, comics, software, logos, etc. Intellectual assets are a great source of passive income, especially when they are in digital format, since this makes them easy to reproduce and distribute.

For instance, you can make a duplicate of an article you wrote by simply clicking 'copy' and 'paste'. These copies can be shared with thousands of people via the Internet and you can earn direct income every time the article is sold, or through royalty fees that are paid to you regularly by the distributor.

If you want to know more interesting ideas and precise methods on how to generate passive income from intellectual assets, I recommend you to read my best-selling book *Secrets of Self-Made Millionaires* (which is, by the way, an awesome read). For now, let us concentrate on making money through savvy investing.

Start Becoming Financially Free from the Rat Race

Once you learn the investing techniques in the chapters that follow, you can immediately start to build a portfolio of businesses and real estate assets that generate multiple streams of passive income. As these assets start to grow in value over time, you will find yourself making more of your money passively from these assets as compared to your active income sources. When the passive income generated from your assets is enough to cover your expenses, you will be financially free from having to work at your day job. You will only work because you choose to and that is what being wealthy truly means. Imagine yourself having the freedom to do only what you love every day. It is something that you can definitely achieve with proper planning and execution!

Your First Step toward Financial Freedom… Decide!

Many people aspire to achieve financial freedom — to have enough liquid assets and passive income to cover all their future expenses, only getting up to work because they choose to.

Unfortunately, the majority of people never reach this level of freedom because they leave it to chance. They have no goals, no plans and take no actions to make their financial dreams a reality.

I am here to tell you that you can become financially free only if you are truly committed towards this goal and follow a concrete plan to get there. Over the last 10 years, I have coached people of all ages to achieve their financial freedom and I believe that with the strategies you will learn from this book, you will be able to do the same.

The first step is to decide on your desired lifestyle! How much do you need to spend a month to sustain your desired lifestyle? Your desired lifestyle will then determine how much money you need to accumulate and the amount of passive income you require to be financially free.

For example, if you have a very simple lifestyle that requires $2,000 per month ($24,000 per year) to sustain, then all you need is a capital of $342,857 invested in an asset that yields 7% per year (like an industrial REIT). This asset will produce an annual dividend of 7% × $342,857 = $24,000 a year. This would be just enough to finance all your expenses. With a regular savings plan, you may be financially free in 5 – 7 years.

However, if you have a more extravagant lifestyle that requires $20,000 per month ($240,000 per year) to sustain, then you will need to accumulate a much larger capital with higher yields to generate the required passive income to finance the higher expenses. You would have to use a shorter term trading strategy to achieve much higher returns in order to achieve this higher target. Instead of 5 – 7 years, it may take you over 10 years instead.

Unless you decide on a lifestyle target, it is impossible to create a financial freedom plan that will help you reach your goals. Let me show you how this process can be done using a financial freedom calculator.

Compute Your Financial Freedom Plan

How much would you need to invest in a year in order to reach financial freedom? To help you find the answer, you can use a 'Financial Freedom Calculator' available at www.wealthacademyasia.com. This calculator has been designed to calculate the amount of money you need to invest regularly to reach your financial freedom target (based on your desired lifestyle).

You need to begin by completing the following data. Please fill in the blanks as you go along.

a. Your current age: _____ years
   Be honest with this one!

b. Financial freedom age: _____ years
   Indicate the age you want to reach financial freedom. To be conservative, it should be at least 6 – 10 years beyond your current age. But who am I to judge?

c. Financial freedom income: $ __________
   How much income do you need to cover your monthly expenses? This depends on your desired lifestyle. Indicate your ideal amount.

d. Inflation rate: _____ %
   Check the inflation rate of your resident country. A 3% – 4% inflation rate would be a rule of thumb.

e. Estimated life span: _____ years
   I don't expect you to predict your own departure but you can input 70 – 80 years based on the average life expectancy.

f. Current liquid assets: $ __________
   How much do you have in liquid assets that can be invested today? This should include your cash savings and investments in stocks, real estate, bonds, ETFs, commodities, etc. Exclude the value of your residential property, CPF and insurance benefits.

g. Rate of return (active and passive): _____ %
   What kind of returns do you think you can achieve with your current level of investing knowledge and skills? Most people who are not savvy investors are happy to get a return of 1% – 3% from their time deposits or 4% – 5% from their unit trust/mutual fund-linked insurance policies.

Rate of return (active) refers to the investment returns you aim to achieve before your financial freedom age. Rate of return (passive) refers to the returns you aim to achieve after financial freedom age. You can input the same figures for both returns.

Go to www.wealthacademyasia.com, open up the financial freedom calculator and input the figures you have indicated. Once you click 'solve', the calculator will calculate the 'annual savings needed to reach financial freedom' and 'total savings needed for financial freedom' Go ahead and see what results you get.

Figure 1.4: Financial Freedom Calculator

Case Example 1: Achieve Financial Freedom Income of $10,000 per Month with Investment Return of 5% p.a. within 10 Years?

Whenever I get my students to do this exercise, many of them get quite a shock, not realizing how impossible it is to achieve financial freedom with a low investment return.

Many people tell me that they have a desired lifestyle/financial freedom income of at least $10,000 per month which they would like to achieve within 10 years. Currently, they have approximately $100,000 in liquid assets and are only able to achieve a return of 5% from their various investments.

After keying in these figures and computing the result, they realize that they have to save and invest a whopping $228,867 per year ($19,072 per month) for the next 10 years to make it happen. Refer to Figure 1.5.

Figure 1.5: Financial Freedom Calculator (Case Example 1)

Of course, it seems impossible to achieve. With an inflation rate of 3% and a rate of return of 5%, their real return is only 5% - 3% = 2%. When your money grows at only 2%, you obviously need to save a tremendous amount in order to have enough to be financially free (and draw $10,000 per month for the rest of your life).

However, if you are able to achieve a higher investment return for your savings, you will find that you need to invest a lot less money in order to achieve the same financial outcome.

So, what returns are realistic? It really depends on how much time you are committed to spending on managing your money. If you only adopt a 'buy and hold' or 'dollar cost averaging' method investing in the right stocks and property assets, you can realistically achieve 8% – 10% annual returns over the long term.

On the other hand, if you learn and apply the active investing strategies I am going to teach you in this book, you will be able to boost your returns to 15% – 25% per year consistently. If you learn how to master advanced trading techniques such as leveraging, you can even achieve returns of 5% – 8% per month (that works out to be 79% returns per year compounded). These are the kinds of returns that I am getting on my leveraged portfolio (I will share more on this with you later). Since most of my students are able to achieve a 20% annual return at the very least, I am going to use this figure in my next case example.

Case Example 2: Achieve Financial Freedom Income of $10,000 per Month with Investment Return of 20% p.a. within 10 Years?

If you would like to achieve financial freedom in 10 years with an investment return of 20% annually, how much would you need to save and invest per year? Using the same inflation rate, current liquid assets and other factors as before, let's take a look at the results below:

Figure 1.6: Financial Freedom Calculator (Case Example 2)

With a rate of return of 20%, you only need to invest $3,300 per year ($275 per month) for 10 years to achieve a financial freedom income of $10,000 per month. What a huge difference!

This demonstrates the huge difference your investment returns can have on your financial future. When you invest $100,000 with an additional $275 per month at a 5% return, it will grow to only $205,512 in 10 years. However, if you invest that same $100,000 and $275 per month at a 20% return, it will grow to $713,859 in 10 years. This huge difference is the result of the power of compounded returns. This is why it is so essential to develop smart investing skills if you want to get rich.

Chart 1.7 shows you how a $600 monthly investment for 20 years grows and compounds at 0%, 5% and 20% return respectively. The effect of compound growth means that your wealth is growing at an exponential rate and not just a linear one.

Chart 1.7: Investing $600 per Month for a Period of 20 Years

Case Example 3: Adjusting the Values to Meet Your Requirements

All of us have different lifestyle requirements and different expectations of when we want to reach our goals. If you find that waiting 10 years to be financially free is too long, you can adjust the financial freedom age to 5 years later and look at the corresponding result. From Figure 1.8, you can see that by saving $61,363 per year ($5,114 per month) at a 20% annual return, you can achieve your financial freedom target in 5 years.

Figure 1.8: Financial Freedom Calculator (Case Example 3)

Similarly, if you adjust the financial freedom income you desire and the current liquid assets entry, you will get a very different result. Take the time to enter values that you are most comfortable with and look at the results that follow.

Successful Investing Is the Key to Building Your Wealth

As you can see, in order to achieve financial freedom, it is absolutely essential for you to learn how to invest in the right assets that will grow your money the fastest over time.

Unfortunately, after spending over 18 years of their lives going through the education system, many people never learn the essential money skills to achieve the financial security and abundance they deserve. They are merely educated to sell their time in a job and to depend on a salary that cannot keep pace with ever escalating expenses.

With this book, I hope to impart to you the essential investing and money management skills that have helped me to achieve the financial abundance and freedom that I now enjoy. If you are ready to embark on this journey of financial education and mastery, turn the page and I am going to start by giving you a crash course on the stock market…

TWO
CHAPTER

A Crash Course on the Stock Market

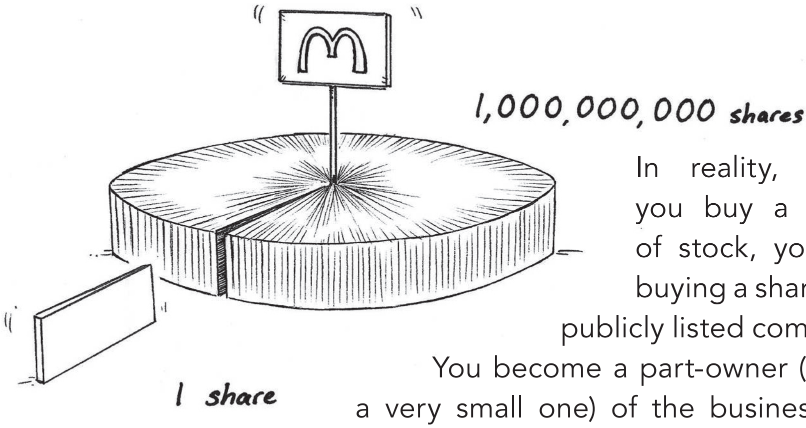
A Crash Course on the Stock Market

CHAPTERTWO

Now that you understand why one of the best ways to build your wealth is by investing in stocks, let's really begin to understand what stocks are and how they can work for you.

What Is a Share of Stock?

Many people treat stocks like lottery tickets and the stock market as one giant casino. Taking this "gambling" approach will almost always lead people to losing their hard-earned money.



In reality, when you buy a share of stock, you are buying a share of a publicly listed company. You become a part-owner (albeit a very small one) of the business. As a shareholder/owner you have the right to a portion of the company's profits and the right to vote on who should run the company and how they should run it.

For example, McDonald's Corporation has 1000,000,000 shares outstanding. What this means is that the company is divided into a billion parts (or shares). These are the total number of shares that exist to be owned. If you bought 2,000 shares of McDonald's, you would technically own 0.0002% of the company. You would be entitled to 0.0002% of the company's profits.

This may not sound very exciting, but consider the fact that McDonald's earned a net profit of US$5,503 million in the financial year (FY) 2012. 0.0002% of that would amount to US$11,006!

How Do I Make Money Owning Stocks?

1) Cash Dividends

So, how do you benefit from your share of the company's profits? Well, as a shareholder of some companies, you get a portion of the profits paid out to you in cash every year. For example, companies like StarHub (listed on Singapore Exchange) pay out more than 100% of their net profit as dividends.

In 2011, you could have bought StarHub shares at $2.36. In that same year, StarHub earned $315.5 million in net profit and had 1,715.3 million shares outstanding. StarHub's earnings per share worked out to be $0.184 ($315.5m ÷ 1,715.3m). The company decided to pay out $0.20 in dividends per share.

If you had bought 5,000 StarHub shares at $2.36, your investment would have been $11,800. As a shareholder, you would have received dividends of $0.20 × 5000 shares = $1,000 earnings for the year.

$$\text{Your dividend yield} = \frac{\$1,000}{\$11,800} = 8.5\%$$

If you had put that same $11,800 into a fixed deposit account, you would have gotten only an interest of less than 1% (or less than $118). This is why owning shares in a profitable company sure beats lending your money to a bank. By holding on to your shares, you will continue to receive your share of profits year after year!

2) Share Price Appreciation

Not all companies pay out dividends to their shareholders. Companies that need cash to grow aggressively (their stocks are called 'growth stocks') will prefer to retain their profit and to use it to reinvest in the business. For example, companies like Google, Berkshire Hathaway and Amazon.com do not pay out any dividends.

These companies may use their cash to buy more equipment, build more shops and factories and expand to more markets. All this will lead to higher future sales and profits, making the company's shares more valuable. Eventually, the share price will rise to a higher price. By selling your shares at a higher price, you pocket the profits. This is known as 'capital appreciation'.

For example, you could have bought one share of Amazon.com at $120 in January 2010, believing that this online retailer has huge growth potential. As the company increased its sales and profits, its share price appreciated to $268 by January 2013. By selling your shares at this higher price, you would have made a net profit of $268 - $120 = $148. Your return on investment would have been $148 ÷ $120 = 123%! Again, this return would beat the miserable 1% – 3% interest you would have gotten from the bank.

Chart 2.1: Going Long on Amazon.com

Credit: www.thinkorswim.com, ProphetCharts®

The concept of buying shares of a company at a lower price in the expectation of selling it at a higher price is known as 'going long'. In Chapter 9, you will learn advanced investing techniques such as profiting from a declining stock. This latter approach is known as 'going short'.

How Many Shares Do I Need to Invest In?

For stocks listed on the US stock exchanges, there is no minimum number of shares you need to buy. You can buy a single share if you wish. The share of a large and well-known company can be as cheap as $7 (Bank of America) to as expensive as $650 (Google) and $1,300,000 (Berkshire Hathaway).

In Hong Kong and Malaysia, the minimum number of shares you need to purchase is one round lot of 100. In Singapore, you have to buy a round lot of 1,000 shares. So if the price of one share of SMRT Corporation is $1.90, you have to buy 1,000 shares that cost $1,900. There will be some commission you have to pay to your broker as well.

How Much Is a Company's Share Really Worth?

Before you buy the shares of any company, you need to have a good idea of how much the company and its shares are really worth. Are you buying the shares at a cheap or an expensive price?

To the untrained investors, shares of Apple may seem expensive at $580 and shares of Facebook may seem cheap at $42. By the end of this book, you would realize that Apple shares are very cheap at $580 since they are worth much more. Buying it at the price of $580 means there is a great potential for price appreciation. At the same time, Facebook's shares were terribly expensive on its first day IPO price of $42. It was worth much less than the stated stock market price. It was no surprise that the stock quickly crashed all the way down to $25!

In Chapter 6, you are going to learn the most accurate way that professionals use to value a company's shares. Meanwhile, in this chapter, I am going to show you a much simpler method to tell if a company's shares are cheap or expensive.

What Is a Company's Worth? A Simple PE Approach!

Remember that when you buy shares, you are actually buying parts of a company. So, you have to first understand how companies are valued before knowing how much each share is worth.

Let me illustrate this with a simple example. If I told you of a successful restaurant business, Yummy Inc. that earns $1 million per year in net profits, what is the most you would pay to buy this entire company? Would you pay $1m, $3m, $5m, $10m or more?

(Assume that this business is run by a great management team with talented waiters/chefs and has a proven track record of earning $1 million of net profits per year. Once you buy the company, you are entitled to its yearly profits.)

Think for a minute and write your answer here.

I would pay $ ___________ to buy this great business.

When I ask most people this question, they would usually answer $3 million to $5 million. That is in fact how much a private company is usually valued at! If a private company earns $1 million per year, it should be worth at least $3 million! Why is this so? Well, if you paid $3 million to buy the business and you earn $1 million of profits per year from it, then you should make back your entire investment within 3 years. Most people think that is a fair deal. After the third year, you would earn $1 million per year in pure passive income.

Introducing the Price-to-Earnings Ratio Concept

As an investor, you must be very familiar with the concept of **'price-to-earnings ratio'** or **'PE ratio'**. It is a ratio that is derived from taking the price of a company and dividing it by the annual net profit (i.e. earnings).

$$\text{Price-to-earnings ratio} = \frac{\text{Price of the company}}{\text{Annual net profit}}$$

(Note: PE ratio is also = $\dfrac{\text{Price per share}}{\text{Earnings per share}}$)

In the previous example, what is the PE ratio of the company you are buying?

$$\text{PE ratio} = \frac{\text{Price of the company}}{\text{Annual net profit}} = \frac{\$3 \text{ million}}{\$1 \text{ million}} = 3 \text{ times}(\times)$$

If you are paying $3 million for a company that earns $1 million in annual profits, essentially, you are valuing the company at a price-to-earnings ratio of 3 times. You are paying '3 × earnings' or a 'multiple of 3'.

What Is the PE Ratio of Most Publicly Listed Companies?

So, if the PE ratio of most private companies is '3 to 5 × earnings' (based on what most people like you and me are willing to pay), what is the PE ratio of most public companies that are listed on the stock exchange?

Let's take a quick look at the PE ratios of some well-known companies that are listed on the US stock exchange (as of June 2012).

Company	Stock Price	PE Ratio (as of 29 June 2012)
Coca-Cola	$77.71	20.64 ×
American Express	$57.90	13.85 ×
IBM	$194.64	14.51 ×
Apple	$577.00	14.08 ×
McDonald's	88.31	16.5 ×
LinkedIn	$106.50	658.75 ×

You can see that on average, based on the stock price, most people are willing to buy these public companies at a PE ratio of 15 ×. This means that for every $1 of net profit they make, people are willing to pay a share price of $15! In the case of Coca-Cola, investors are willing to pay a price of \$20.64 for every \$1 of net profit the company makes.

Coca-Cola's earnings per share is \$3.77 (the total net profit divided by the total number of shares outstanding). Coca-Cola's share price is \$77.71.

So, the PE ratio of Coca-Cola $= \dfrac{\text{Price per share}}{\text{Earnings per share}} = \dfrac{\$77.71}{\$3.77} = 20.61$

Does this mean that investors are willing to wait 20 years to earn back the amount they have invested? This does not sound logical, right? Let me explain.

The reason investors are willing to pay a price of 20 times the earnings for Coca-Cola is because they expect the company's net profit to <u>increase</u> every year! For example, if Coca-Cola's profits can increase by 20% every year, then the investor would earn back his investment fairly quickly.

PE Ratio, Earnings Growth Rate and PEG Ratio

Peter Lynch, the legendary fund manager, found that a company's PE ratio should be equal to its projected **earnings growth rate**. When this happens, it means the company is fairly priced.

> For a fairly priced company…
>
> PE ratio = Earnings growth rate

This means that if the company's net profits (i.e. earnings) are growing at 20% every year, the company stock's PE ratio should be 20 ×.

Peter Lynch also came up with the **PEG ratio** to determine if a company is expensive or cheap. The PEG ratio is derived from taking the PE ratio and dividing it by the earnings growth rate.

$$\text{PEG ratio} = \frac{\text{PE ratio}}{\text{Earnings growth rate (EGR)}}$$

If the EGR is 20% and the PE ratio is 20 times, then the PEG ratio will be equal to 1. This means the stock is fairly priced.

If the PE ratio is greater than the EGR, then the PEG ratio will be greater than 1. This means the stock is expensive.

If the PE ratio is less than the EGR, then the PEG ratio will be less than 1. This means the stock is cheap.

Using PEG Ratio to Compare Companies

Let's use what you have learned to see if Apple or IBM is the cheaper and more attractive stock to buy. Let's look at the facts and figures (as of 26 February 2013).

	Apple Inc. (AAPL)	IBM (IBM)
Stock price	$442.80	$197.51
PE ratio	10.04 ×	13.95 ×
Earnings per share	$44	$14.40
Earnings growth rate	18.98%	9.86%

To most untrained investors, Apple may seem more expensive to IBM since it is selling at $442.80 versus $197.51 and both PE ratios seem to be about the same. Calculating the PEG ratio will give us a much clearer picture.

$$\text{Apple's PEG ratio} = \frac{0.04}{18.98} = 0.53$$

$$\text{IBM's PEG ratio} = \frac{13.95}{9.86} = 1.41$$

Although Apple's PE ratio is 10.04, its profits are projected to grow at 18.98% per year on average. This results in a PEG ratio of only 0.53, meaning that Apple shares are currently selling very cheaply.

At its fair price (i.e. PEG = 1), Apple's PE ratio should be 18.98 ×, equaling its EGR. Since Apple's earnings per share is $44, its share price should be selling at $44 × 18.98 = $835.12.

On the other hand, IBM's PEG ratio is 1.41, making it expensive. Even though its projected EGR is only 9.86%, its PE ratio is a high 13.95 times!

As an intelligent investor, which company's stock would you invest your money in? Which stock has a better chance of appreciating? The obvious answer is Apple.

What Makes Share Prices Fluctuate Daily?

You can check out the prices of your favorite stocks at any time by looking at stock investment websites and from your online stock broker.

You can see that stock prices of companies change rapidly every second, going up and down as the day progresses. Share prices can either end up higher or lower at the end of each trading day (9.30a.m. – 4p.m. EST in the US and 9a.m. – 5p.m. in Singapore).

In the short term, stock prices may not always reflect the true value of the company. In the case of Apple, we know that the stock should be worth at least $820, but at the time of my writing, the shares are being priced at only $577. By the time you are reading this book, it would be selling at a much different price!

What Makes Share Prices Go Up?

So, what is causing these stock prices to move up and down? The answer is **demand** and **supply**. On a certain day, when people are optimistic because of some good news (e.g. the economy is reported to grow more than expected), there will be more people desperate to buy shares than there are people wanting to sell their shares.

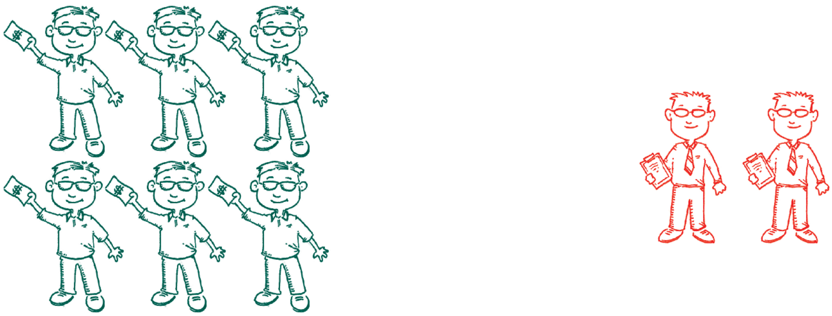
Since there are more people wanting to buy than people wanting to sell, the optimistic buyers (known as the **'bulls'**) will offer a higher and higher price to entice more sellers (known as the **'bears'**) to sell their shares. This causes the share price to be transacted at a higher price. The share price thus jumps up.

Remember that for every buyer of a company's stock, there must be a seller. The buyer believes that the share price will go up and the seller believes that the share price will go down. So, they make a transaction.

In Illustration 2.2, it happens to be an optimistic day, so there are more potential buyers (6 million) than potential sellers (3 million). Buyers will always offer (**'bid'**) to buy at a certain price (e.g. $11). Sellers, wanting to get a better deal will always **'ask'** for a higher price (e.g. $12). The difference between the 'bid' and the 'ask' price is called the **'spread'** (e.g. $1).

So, who is more desperate? The bulls or the bears? Since there are more buyers desperate to buy, they would likely increase their bid price to match the seller's ask price of $12. When both parties agree to a sale, the share price is done at $12. This is known as the **'last done price'**.

Illustration 2.2: An Optimistic (Bullish) Day



Buyers (bulls) bid $11

Sellers (bears) ask $12

Buyers increase bid to $12

Last done $12
(Bid = Ask = $12)

However, after the 3 million buyers have bought from the 3 million sellers, there are no more sellers left! The remaining 3 million buyers will have to keep raising their bids until they attract sellers to emerge and sell at the higher price. In this case, the buyers have to offer $15 before enough sellers agree to sell. The share price is then done at $15.

Buyers (bulls) bid $15

Sellers (bears) ask $15

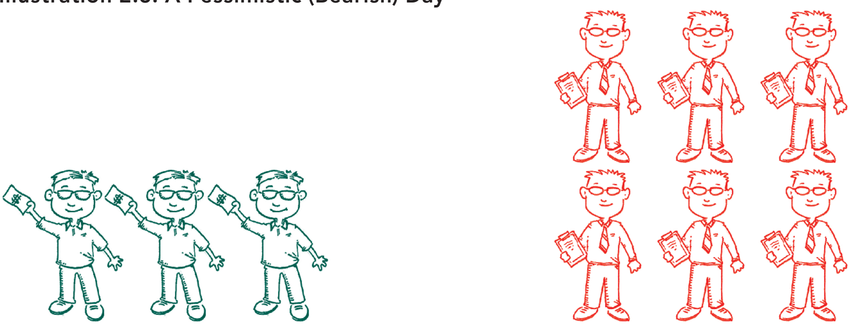
Last done $15
(Bid = Ask = $15)

So you can see that if you are rich enough, you can single-handedly increase a company's share price by offering to buy more and more shares at a higher price! At times, extreme optimism can cause a company's share price to increase to such high levels that it becomes overpriced!

What Makes Share Prices Fall?

At the same time, what causes share prices to fall? Usually when there is bad news (e.g. reports that the economy is slowing or that the company made an unexpected loss), there will be more potential sellers (bears) emerging than potential buyers (bulls).

Illustration 2.3: A Pessimistic (Bearish) Day



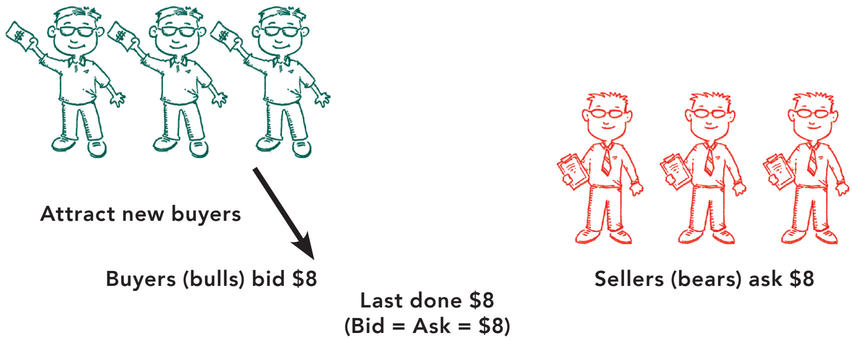
Buyers (bulls) bid $11

Sellers (bears) ask $12

Sellers lower ask to $11

Last done $11
(Bid = Ask = $11)

In Illustration 2.3 (a pessimistic day), there are more potential sellers (6 million) than potential buyers (3 million). Since the sellers are now more desperate to get out of the market, they are willing to lower their ask price to $11 so that the buyers will buy their shares. The share price consequently falls to $11.



After the 3 million sellers have sold to their 3 million buyers at $11, there are still 3 million potential sellers left and no one else willing to buy. In desperation, the sellers will keep lowering their ask price to $8, until buyers come and agree to buy. Hence, the share price falls to $8. This is the mechanics behind how a share price decline takes place.

As you can see, share price movements are really driven by the <u>emotions</u> of millions of investors. These emotions are caused by news about the economy or the individual company. When people start to get excited and optimistic, they will drive share prices much higher. When they are fearful and pessimistic, they will cause share prices to fall.

In the short term, shares prices do not always reflect the true value of the company. This gives smart investors the opportunity to buy shares when they are priced lower than what the company is worth and to sell when they are overpriced, thus making a profit!

This is exactly what you are going to learn to do in the chapters that follow.

Understanding Stock Exchanges and Indexes

The stock market is where millions of buyers and sellers meet every day to buy and sell shares of publicly listed companies. The stock market is literally a supermarket of companies. It has become a virtual marketplace since the transactions now take place over the Internet.

Companies are listed on stock exchanges all over the world. To be a successful investor, you have to invest in companies listed on different exchanges — wherever the best opportunity presents itself. Take a look at some of the different stock exchanges around the world. A stock exchange is itself a company that you can invest in.

Stock Market	Main Stock Exchanges
United States	New York Stock Exchange (NYSE) NASDAQ Stock Market American Stock Exchange
Singapore	Singapore Exchange (SGX)
China	Shanghai Stock Exchange Shenzhen Stock Exchange Hong Kong Stock Exchange
Malaysia	Bursa Malaysia
London	London Stock Exchange
Tokyo	Tokyo Stock Exchange

Stock Indexes Measure the Performance of a Stock Market

Thousands of companies can be traded on a particular stock market. In the US stock market, there are over 10,000 companies being traded over the various exchanges.

How do we know how well a stock market is performing? We use **indexes** to measure the performance of a stock market. An index is a basket of stocks that is used to represent the entire market (or segment of the market). There are many indexes that are used to measure different aspects of the market.

US Stock Indexes

There are three main indexes used to measure the health of the US market. They are the Dow Jones Industrial Average, the S&P 500 index, and the NASDAQ-100 index.

Dow Jones Industrial Average

The Dow Jones Industrial Average ('Dow') is an index that is made up of the 30 largest companies in the entire US market. These 30 companies have been selected to represent the different sectors of the economy.

The Dow price is calculated by taking the weighted average price of these 30 largest companies that include Coca-Cola, American Express, Walmart, Microsoft, Procter & Gamble, McDonald's, Bank of America, IBM, 3M, Honeywell, Boeing, Pfizer, etc.

S&P 500

The S&P 500 is another index that comprises the 500 largest companies in the US market. Again, the S&P 500 index price is calculated by taking the average price of the 500 largest companies' stock prices. These 500 stocks essentially represent the entire US market.

NASDAQ-100

Finally, the NASDAQ-100 is an index that represents the technology sector of the US. Most of the largest technology companies in the US like Google, Apple, Amazon.com and Facebook are listed on the NASDAQ Stock Market. The NASDAQ-100 index is calculated by taking the average price of the 100 largest stocks in this exchange.

When all three indexes are rising, the US market is bullish and when all three indexes are declining, the US market is considered bearish.

Singapore Stock Indexes

The Singapore stock market is represented by the Straits Times Index (STI). The STI is calculated by taking the average price of the 30 largest stocks on the Singapore Exchange. This includes stocks like SMRT, UOB, OCBC, Keppel Corp, SIA, SingTel, StarHub, Noble Group, Asia Pacific Breweries, CapitaLand, Dairy Farm, Jardine C&C, Singapore Press Holdings and Singapore Airlines.

Here is a list of the indexes used to represent some of the other stock markets around the world.

Table 2.4: Major Stock Market Indexes

Market	Index	Composition
Singapore	Straits Times Index	Capitalization-weighted average* of the 30 largest stocks on the Singapore Exchange
Hong Kong	Hang Seng Index	Capitalization-weighted average of the 45 largest stocks on the Hong Kong Stock Exchange
Malaysia	Bursa Malaysia Kuala Lumpur Composite Index	Capitalization-weighted average of the 30 largest stocks on the Bursa Malaysia
China	SSE Composite Index	The SSE Composite Index is a Paasche weighted index* of all stocks (A and B shares) traded at the Shanghai Stock Exchange

Japan	Nikkei 225	Price-weighted average of 225 stocks listed on the Tokyo Stock Exchange
London	FTSE 100	Capitalization-weighted average of the 100 largest stocks on the London Stock Exchange
Indonesia	JSX Composite Index	Capitalization-weighted average of all stocks on the Jakarta Stock Exchange

* *'Capitalization-weighted average' refers to the average figure derived from the market capitalization of a certain number of stocks in an index. In such calculations, larger companies would take up a greater portion of the index.*

* *'Paasche weighted index' is a form of weighted aggregate price index where prices are assigned weights equal to the corresponding quantities consumed in the current year.*

How Have Stock Indexes Performed over Time?

So, how have the different stock market indexes performed over time? Would you have made money if you had invested in the stock market? Let's start by looking at the largest stock market in the world, the US market, which is represented by the S&P 500 index.

Chart 2.5: S&P 500 Index, 1960 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

If you study the price chart of the S&P 500 index, you will realize that in the short term, prices are volatile, going up and down like a rollercoaster. However, in the long term, the value of the index keeps trending up, making higher highs and higher lows.

If you had invested $1,000 in the index in 1960, it would have grown to be worth $25,225 today. The S&P 500 has achieved a total return of +2,422% and an annual compounded return of 8.36% (with dividends included).

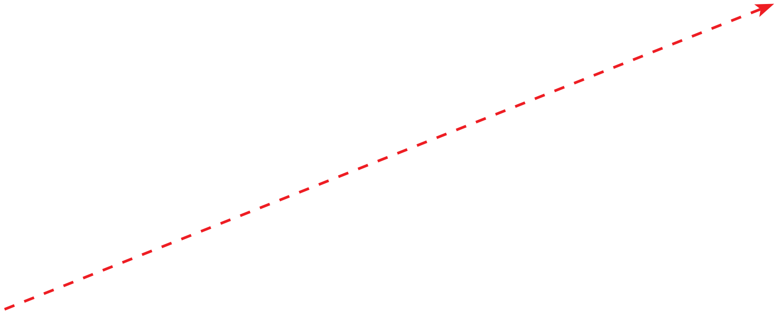
This means that if you were to invest your savings in the index and leave it to compound over many years ("close your eyes"), you would easily be growing your money at 8% – 12% annually over the long term. Isn't that a much better deal than investing your money into the bank's fixed deposit and earning a meager interest rate of less than 2%? It even beats investing in government and company bonds, which have only grown at a rate of 5% – 6%. Even a novice can make money in the stock market if he has the patience to hold for the long term.

You can bet that the S&P 500 index will continue to go up and be selling at higher prices in the years to come. There are three factors that ensure that the S&P 500 index (and other stock indexes) will always increase over time. They are inflation, population growth and change in the index stocks.

A Look at Other Indexes

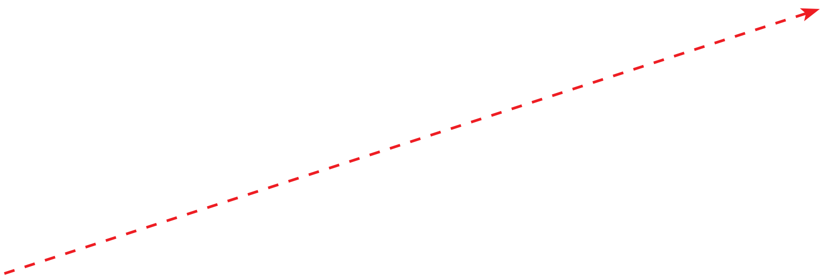
Do other stock market indexes trend higher over time as well? If you take a look at the charts below, you can see that in fact, other indexes rise over time as well.

Chart 2.6: Singapore Straits Times Index 1987 – 2012



Credit: www.yahoo.com/finance

Chart 2.7: Hong Kong Hang Seng Index 1990 – 2012



Credit: www.yahoo.com/finance

Comparison of Stock Market Indexes

Table 2.8 shows how the different stock market indexes have performed against one another over the last 10 years (Jan 2003 – Jan 2013).

Table 2.8: Comparison of Stock Market Indexes (Jan 2003 – Jan 2013)

Index	Period	Years	Compounded Annual Return	Average Dividend Yield	Total Annual Return
S&P 500	2003-2013	10	5.56%	2.64%	8.2%
Singapore STI	2003-2013	10	9.56%	2.79%	12.35%
Malaysia KLCI	2003-2013	10	9.79%	2.84%	12.63%
London FTSE 100	2003-2013	10	5.43%	3.29%	8.72%
Shanghai Index	2003-2013	10	4.28%	1.77%	6.05%
Hang Seng Index	2003-2013	10	9.62%	2.84%	9.46%
Bombay SE Sensex	2003-2013	10	19.8%	1.5%	21.3%
Jakarta C. Index	2003-2013	10	27.3%	1.95%	29.25%

Credit: www.yahoo.com/finance

Being a Global Investor

Which stock markets should you invest in? Well, it always makes sense to invest in your local market because you would tend to be familiar with the companies that are listed there. As a Singaporean, I would be a lot more familiar with companies like SMRT, StarHub, CapitaLand, UOB and VICOM. I would thus have an edge in understanding these companies as compared to foreign investors.

At the same time, I also love investing in the US market, as it is where I have generated the greatest profits. Although the US market may be based thousands of miles away, it offers investors some unique advantages:

1) Global Companies

The majority of US stocks that I invest in are not really local US companies. They are in fact global companies that sell products/services that I use on a regular basis. I invest in these companies because I use their products and know how successful they are.

For example, I eat at McDonald's, use Visa credit cards, use Procter & Gamble household products, bank with Citigroup and am a big fan of Apple products. My investment in these companies (McDonald's, Apple, P&G, Visa, etc.) has generated huge returns for me. I would bet that most of the products you use are made by US companies rather than companies based in your country.

2) High Liquidity

The other reason investing in US stocks is highly profitable is because of the tremendous liquidity and volume in the US market. What this means is that there are more buyers and sellers with billions of dollars that pour into US companies as compared to local companies. It is only when there are enough buyers/sellers that the price of a stock rises (and falls).

There are many great companies listed on the Singapore, Malaysia and Hong Kong stock markets. However, when there are not enough buyers around to provide the money (liquidity), the share price may not move up very much to reflect the true value of the company. You can sometimes buy a great stock and sit on it for months or years without seeing it move up!

The US market, on the other hand, is a lot more efficient. The huge liquidity ensures that there are enough buyers to drive a good stock upward and enough sellers to drive a bad stock downward.

3) Free Access to Research Data

To be a successful investor, you need to have access to analysis tools that help you to analyze how good a stock is. You need to use charts and be able to analyze a company's financial data in order to come to a good decision.

In the US market, most of these tools are available for free online. For example, I can search/screen for US companies that have the highest profit growth, dividend payouts and lowest debt on many free websites. These tools and data give me an edge and provide an equal playing field among professional investors that work for million-dollar funds, research companies and me.

Unfortunately, these tools are not always available for free in other markets.

4) Lower Investing Commissions and Tax Exemption

Finally, it is a lot cheaper to invest in US stocks than in stocks of most other markets. As mentioned before, you have to buy a minimum of 1,000 shares in Singapore and 100 shares in Hong Kong. In the US, you can simply buy one share.

With the Internet, I am able to buy US stocks from Singapore with just a click of the mouse and pay much less in commissions by using discount brokers. The other advantage of buying US stocks as a foreigner is that you are not subjected to capital gains tax. All the profits you earn are tax-free. You are only subjected to withholding tax on dividends that are paid to you.

Beating the Index Is the Name of the Game

As you can see from the charts, making money from the stock market can be fairly straightforward. If you invest in the index (made up of the largest companies) and hold it for the long term, you can expect your money to grow 8% – 12% annually.

However, am I suggesting that you hold for the long term and get these returns? Nope! In this book, I am going to share with you strategies that professionals use to get much higher annual returns of 15% – 35% or more, without having to hold for the long term.

In today's volatile market, holding through the huge ups and downs is not the most effective way to grow your money. As a smart investor, you have to learn when to get out of the market before it makes a huge decline and to get in when it starts a big advance. In this way, you will boost your returns significantly!

At the same time, you are going to learn how to pick only the winning stocks within the index, so that the weaker companies in the index don't pull down your returns. Are you ready to begin?

Not All Stocks Are Built the Same

In order to find the best performing stocks in the market, you have to first understand how stocks are classified into categories. During different points in the market cycle, different stock categories will perform better than others.

Classifying Stocks into Sectors

The first way to group stocks is into sectors within the market. Stocks within the same sector are in similar businesses and have a tendency to move together (movement in sympathy).

Standard & Poor's (S&P) divides the entire US market into 9 distinct sectors. Listed below are the 9 sectors and largest companies within each sector.

1) **Consumer Discretionary Sector**
   Home Depot (HD), Target Corp (TG), Lowe's Cos (LOW), Nike (NKE), Walt Disney (DIS), Time Warner (TWX)

2) **Technology Sector**
   Apple (AAPL), Google (GOOG), IBM (IBM), Intel (INTC), Cisco Systems (CSCO), Microsoft (MSFT)

3) **Finance Sector**
   Citigroup (C), JP Morgan (JPM), Bank of America (BAC), Goldman Sachs (GS)

4) **Industrial Sector**
   Deere (DE), General Electric (GE), 3M (MMM), Caterpillar (CAT), United Technologies (UT)

5) **Materials Sector**
   Dow Chemical (DOW), Nucor (NUE), Alcoa (AA), DuPont (DD), Monsanto (MON)

6) **Energy Sector**
   Exxon Mobil (XOM), ConocoPhillips (COP), Chevron (CVX), British Petroleum (BP)

7) **Consumer Staples Sector**
   Procter & Gamble (PG), Walmart (WMT), PepsiCo (PEP), Colgate-Palmolive (CL), Coca-Cola (KO), Kimberly Clark (KMB)

8) **Health Care Sector**
   Johnson & Johnson (JNJ), Pfizer (PFE), UnitedHealth (UNH) WellPoint (WLP), Abbott Laboratories (ABT)

9) **Utilities Sector**
   Duke Energy (DUK), Exelon (EXC), NextEra (NEE), Dominion Resources (D), Southern Co. (SO)

The finance, consumer discretionary, technology, industrial and materials sectors are all known as **'cyclical sectors'**. These sectors tend to be correlated with the health of the economy. Stocks in these sectors perform very well when the economy is booming and decline the most when the economy goes into recession. They are the most volatile but offer the highest returns.

On the other hand, stocks in the utilities, health care, consumer staples and energy sectors are more recession-proof. Such stocks are known as **'defensive stocks'**, as consumers and businesses have to purchase their products/services even if the economy is not doing well — they are essentials. As a result, they tend to perform better when the economy is contracting and underperform when the economy is booming. They are much less volatile but have much less growth potential as compared to the cyclical sectors.

In Chapter 8, I will explain these sectors in greater detail and you will learn how to use this knowledge to build a winning portfolio. You will learn the best time to invest in cyclical sectors and the best time to get out of cyclicals and into defensive stocks.

As a savvy investor, you will also identify opportunities when a particular sector has much greater potential than other sectors. This is the time to focus more on companies in those hot sectors. For example, as a result of the US and European financial crisis, the materials, finance and housing sectors have taken the hardest hit. It would have been a good idea to avoid these sectors when the crisis hit and to start investing in them when economies started to recover from the crisis.

Classifying Stocks by Market Cap

Another way to classify companies (and their stocks) is by how large they are. Their size is measured by their **market capitalization** ('market cap'). A company's market cap is determined by how much it is currently worth on the stock market. This tells you how much it would cost to buy the entire company. You can calculate the market cap of a company by taking the current price of one share and multiplying it by the total number of shares outstanding.

Market cap = Share price × Number of shares outstanding

For example, the current price of one Apple share is $577 (at my time of writing). Apple Inc. has approximately 900,000,000 shares outstanding. So, Apple's market cap is $442.80 × 900,000,000 = $398.5 billion. It would cost you $398.5 billion to buy every single share of Apple and to own the entire company yourself!

Companies can be divided into 5 categories based on their market cap. These categories are **mega cap, large cap, mid cap, small cap and micro cap**.

1) Mega cap: Over $200 billion
   (Examples: Apple, Exxon Mobil, PetroChina, General Electric)

2) Large cap: $10 billion – $200 billion
   (Examples: UOB, Genting International, Google, McDonald's)

3) Mid cap: $1 billion – $10 billion
   (Examples: Olam, Hyflux, Amway)

4) Small cap: $300 million – $1 billion
   (Examples: OSIM International, Biosensors, Raffles Medical Group)

5) Micro Cap: $50 million – $300 million
   (Examples: Standard Register, New York Mortgage Trust)

Mega Caps and Large Caps: Safer but Less Exciting

It is very important to know the size of the companies you are investing in. Mega caps and large caps tend to be very established industry market leaders and have very strong brands and competitive advantage. They tend to have much more predictable and stable revenue and profits. At the same time, they are usually very financially strong and able to weather recessions and market downturns.

These huge companies tend to be much safer and their stock prices are less volatile. However, because they are so huge, they have less growth potential than smaller companies.

On the flip side, it is very difficult for such companies, like McDonald's, Coca-Cola or IBM, to double or triple in size. Most of these large companies tend to grow at a rate of 5% – 15% annually. However, there are some mega caps like Apple and Google that have been able to grow at 50% – 90% a year.

During major recessions, certain large caps have been known to fall by as much as 30% – 50% in value. It is during these times that you can buy them at huge discounts and double your money when they recover. The good thing about large caps and mega caps is that they are usually the first to recover from a recession.

Mid, Small and Micro Caps: More Exciting but Riskier

If you are the kind of investor that is looking to increase your investments by 100% – 500%, then mid, small and micro caps are for you.

These smaller companies are usually less established local/regional players with weaker competitive advantage and brands. However, they may have the potential to become huge international players one day. After all, every mega or large cap started off as a small or mid cap. Imagine if you had bought Apple when it was still a small cap, 30 years ago while it was selling at $9!

These smaller stocks may seem more affordable (given their lower price), but they are much riskier. They are less financially strong and can easily go bankrupt if they are hit by a severe recession or outgunned by a stronger competitor. It is not uncommon for small caps to fall in price by 50% – 90% when their sales and profits fail to deliver.

In Chapter 5 & 6, you will learn that when investing in small or micro caps, you have to spend a lot more time analyzing the company's debt and cash flow situation.

Personally, I have 80% of my portfolio invested in large/mega caps and only 20% of my money in mid/small caps. However, it really depends on your risk-to-return appetite!

How Do I Know When a Stock Has the Potential to Rise?

One of the most common questions that people ask me is, "How do you know which stock is going to appreciate in price?" After all, as investors, we want to buy a stock at a lower price and to sell it at a much higher price.

There are two ways to analyze a stock's potential to increase in price. The 1) logical approach and the 2) emotional approach.

1) Logical Approach (Fundamental Analysis)

Logically, a company's share price should increase when the company gets more valuable. A company becomes more valuable when it is able to increase its sales revenue, net profit and cash flow. We can determine a company's ability to do this by analyzing its competitive advantage, its current sales and profits, its financial projections, its management decisions and its assets and liabilities. This is known as '**fundamental analysis**'.

Through fundamental analysis, we can determine a company stock's intrinsic (true) value. In the short term, stock prices go up and down based on market sentiment (emotions). However, over time, a company's stock price will tend to move toward its intrinsic value.

Savvy investors use fundamental analysis to find companies that have a much higher intrinsic value than where the share price is today. They believe that the share price will eventually increase toward its true value, allowing them to earn a profit.

For example, if you do a fundamental analysis on CapitaLand (listed on Singapore Exchange), you will find that its intrinsic value is $3.60 per share. Analyzing the company's financial data will show you that the company is financially strong with high growth potential and a strong competitive advantage.

As I am writing this book (June 2012), CapitaLand's share price is selling at only $2.45. Using fundamental analysis (logic), we would definitely buy the stock at this price, knowing that it would eventually rise to $3.60 (or more) in the future.

The reason it is selling below its true value is because of the current negative market sentiment (emotions). Investors, fearful that the debt situation in Europe will get worse, are selling shares more than they are buying, causing the share price to fall in the short term.

2) Emotional Approach (Technical Analysis)
In the short term, the stock market is driven by emotions (sentiment) and not logic. Contrary to academic belief, the market is not always efficient and investors do not always make rational decisions.

Remember that what makes share prices rise and fall everyday is what buyers and sellers are willing to pay. When buyers get more optimistic and greedy and outnumber sellers, they will bid prices up. When sellers get more pessimistic and fearful and outnumber buyers, they will drive prices down. The emotions of fear and greed are what drive the direction of stock prices in the short term.

By using technical analysis to study chart patterns, we can tell if investors are getting more and more optimistic (price uptrend) or more and more pessimistic (price downtrend). Technical analysis is therefore the study of emotional patterns that are captured on stock price charts.

Savvy investors who use technical analysis buy a stock when it is on an uptrend. The increased optimism is what pushes the stock price higher, making them a profit. At the same time, we want to sell a stock when it is on a downtrend. The increased fear and pessimism drive their prices lower.

Which Method Do I Use? Fundamental or Technical Analysis?

Some investors rely purely on fundamental analysis. They ignore the short-term emotions of the stock market and buy knowing that in the long term, the shares of their company will rise to meet its true logical value. This is the method used by Warren Buffett and the late Benjamin Graham (the father of value investing).

Can you follow these gurus and purely use fundamentals? The answer is yes, but only if you are prepared to hold for the long term (5 – 10 years or more). Warren Buffett's holding period is usually over 15 – 20 years!

From Chart 2.9, you can see that stocks can take a few years before they rise to reach their true fundamental value. When the market is pessimistic and on a downtrend, cheap stocks can get much cheaper and they may only recover a few years later. You therefore need lots of patience if you rely on fundamentals alone.

Many fundamentals-only investors bought Whole Foods Market's stock (WFM) at $35 in 2008, believing that the company's true value was worth $65. Unfortunately, because of negative emotions of the market, the price continued to fall from $35 all the way to $8 before it started to recover. Eventually, the price of WFM did rise to $65 and beyond in 2012. However, the investor who bought at $65 needed to have a lot of patience to wait 5 years for the investment to bear fruit.

Chart 2.9: Whole Foods Market (WFM) 2007 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

Winning Formula: Fundamentals + Technicals

I have found that the best investors/traders who are able to consistently make money in both the short and long term use both fundamental and technical analysis. They look at both the logic of what a company is worth as well as the current emotions driving the market.

Fundamental analysis tells you the potential value of the stock and technical analysis helps you determine when investors feel optimistic enough to drive the stock to its true value. Gurus like George Soros, Victor Sperandeo ('Trader Vic') and William O'Neil achieve returns of 25% – 60% annually by combining the two disciplines.

Personally, I used to be a pure fundamentals-driven investor. In those days, I used to have to wait for a few years before my stocks rose to become profitable. In the short term, I would sometimes see my stocks go down 10% – 30% first during a temporary bad market situation before eventually recovering and rising to its true potential.

Sometimes, fundamental analysis would tell you that a stock is a great buy as it is selling at a very cheap price. However, if you buy the stock at the wrong time (when the market is pessimistic and on a downtrend), that good cheap stock could become even cheaper for a while.

A Good Cheap Stock Can Get Even Cheaper

On 15 July 2011, a research analyst from a renowned stock broking company set a target value price of $3.96 for CapitaLand. Indeed, based on the company's profits and net tangible assets (you will learn about this later), the stock should be worth $3.96 – $4.00.

At that time, the stock was selling for $2.80. However, because the market sentiment was still pessimistic (due to the European debt crisis), the stock price continued to slide even lower, all the way to $2.10, before reversing to an uptrend.

If you had solely listened to the analyst's recommendation and bought in at $2.80 while it was still on a downtrend, you would have had to see your investment fall by another 25% before recovering 7 months later. Imagine having your money stuck in a losing investment for a year!

Once I learned the art of reading the emotions and trends of the market using technical analysis, I was able to avoid putting my money in stocks that went down in the short term. I learned how to intelligently time my buys such that I only invest at the right time, when the stock is ready to rise! I learned how to enter a stock when the emotions of the market starts to get optimistic and when the price is on an uptrend. Although CapitaLand was undervalued for over a year, I bought it only in February 2012 at $2.95, just as it started its uptrend all the way to $3.80. In the next chapter, I am going to show you how I identify the beginning of these price uptrends.

Chart 2.10: CapitaLand Price Chart 2011 – 2012

Credit: www.chartnexus.com

Sure enough, when I began combining technical analysis with fundamental analysis, I found myself being able to achieve much greater profits in a much shorter period of time!

When the market turned pessimistic again and started to decline, I knew when to get out and protect my profits instead of having to see my profits evaporate as the stock price fell back down.

In the next chapter, you are going to start learning how to determine the direction of investors' emotions by learning how to read stock charts and determine price trends.

THREE
CHAPTER

Technical Analysis: Reading the Emotions of the Market

Technical Analysis: Reading the Emotions of the Market

CHAPTER**THREE**

"I bought the stock of a good company recommended by expert analysts. Why does it keep going down?"
"The company just announced higher sales and profits and yet the price is falling because of the European debt crisis. It does not make sense!"
"This stock is so expensive and yet the price continues to rise. Why?"

At times, the stock market may not make sense to investors who rely purely on logic to evaluate the financial strength and fundamental value of a company. This is because stock prices are driven by demand and supply, which is in turn driven by the emotions of fear and greed in the short term.

To make money consistently, it is not enough to only determine if a stock is good. Equally important, we must determine if it is a good time to buy (or sell) the stock. The best time to buy is when the market is optimistic. This is when buyers are willing to bid higher prices, causing upward share price momentum. The best time to sell is when the market is pessimistic. This is when sellers lower their asking price in desperation, causing downward price momentum.

Can You Really Predict the Emotions of the Market?

Indeed, it is really difficult to predict the emotions of a person, let alone the aggregate emotions of millions of players in the stock market. (I even find it hard to predict my wife's mood the next day!) On one day, the market can be pessimistic because of some bad news (e.g. rise of unemployment) and the next day it can get optimistic because of a piece of good news (e.g. the US Federal Reserve cuts interest rates). This is why stock prices can fall one day and rally the next. The same company can be priced differently by the market on two different days!

While it is almost impossible to predict the market's emotions on a daily basis, it is possible to identify periods of increasing pessimism (bearishness) and increasing optimism (bullishness) by studying price patterns on stock charts. These periods can last for weeks and months. Let's see how we can identify them on stock charts.

How to Read Stock Charts

Stock charts give us a visual record of past stock prices. By studying these price patterns, we can identify whether the market is in a period of increasing optimism (uptrend) or increasing pessimism (downtrend) or a period of uncertainty (price consolidation).

Before you can understand how to read prices on a chart, you have to be familiar with a stock's **opening price, closing price, day high price and day low price**. A typical US trading day starts at 9.30a.m. and ends at 4p.m. Eastern Standard Time (EST). For most Asian markets, it starts at 9a.m. and ends at 5p.m. When the market first opens, stocks start changing hands at different prices.

The first transacted price of the day is known as the 'opening price'. In the chart below, the opening price of McDonald's was $99.70. During the day, prices will go up and down. The highest price reached during the day is called the 'day high' (e.g. $100.30) and the lowest price reached is called the 'day low' (e.g. $99.45). When the market closes at 4p.m., the last transacted price is known as the 'closing price' (e.g. $99.99).

If the closing price is higher than the opening price, it is known as a bullish day. If the closing price ends up lower than the opening price, it is known as a bearish day.

Chart 3.1: Intraday Chart of McDonald's on 17 Feb 2012

Credit: www.thinkorswim.com, ProphetCharts®

The simplest type of chart is known as a '**line chart**'. Line charts only show you the closing prices of a stock over a period of time. It connects the closing prices with a line. These charts are not very useful in telling us the emotional patterns of the market.

Chart 3.2: Line Chart of Exxon Mobil (Feb 2009 – Nov 2011)

Credit: www.thinkorswim.com, ProphetCharts®

Japanese Candlestick Chart

The most common type of chart used by professional investors today is known as the **'Japanese candlestick chart'**, used by the Japanese for over 400 years.

Candlesticks tell us a lot more about the emotional patterns of investors as they reveal to us the opening, closing, high and low prices during each trading day (or weeks/months).

Chart 3.3 Candlestick Chart of Exxon Mobil (Feb 2009 – Nov 2011)

Credit: www.thinkorswim.com, ProphetCharts®

Reading Prices on Candles

Charting software allows you to configure your charts to daily, weekly or even monthly candles. In this case, we are looking at daily candles over a period of 2 years. Each candle represents one trading day.

A bullish (white) candle is shown when the day's closing price is above the day's opening price. The bottom of the candle's body shows the opening price and the top of the body shows the closing price. The line protruding from the top of the candle is called the 'upper shadow' and shows the high price of the day. Similarly, the lower shadow shows the day's low price.

Figure 3.4: Bullish and Bearish Candles

A bearish (red) candle is shown when the day's closing price is below the day's opening price. This time, the top of the candle's body shows the opening price and the bottom of the body shows the closing price. The upper and lower shadow represent the day high and day low price respectively.

Identifying Stock Price Trends

As mentioned earlier, it is almost impossible to predict the emotions of the market on a day-to-day basis. However, when you look at the patterns of prices on a stock chart, it is possible to tell if the market is getting more optimistic about a stock, more pessimistic, or simply uncertain.

Price Uptrends

When the market gets more and more optimistic about a particular stock (or index), it is translated into a pattern known as an 'uptrend'.

An uptrend is characterized by a series of stock prices making <u>higher</u> high points and <u>higher</u> low points. On an uptrend, stock prices still go up and down. However, every time prices go down, they move up even higher subsequently.

Chart 3.5: Stock Price on Uptrend

Credit: www.thinkorswim.com, ProphetCharts®

When a stock is on an uptrend, it means that investors are getting more optimistic about it. This causes upward price momentum that drives the stock higher and higher. This will keep happening until a major news development changes the trend.

It definitely makes sense to only buy a stock when it is on an uptrend because the probability is that it will keep going higher. This is also known as 'going long' on the stock. This is why there is an old Wall Street saying, "The trend is your friend."

Drawing a Trending Support Line

Chart 3.6: Stock Price on Uptrend with Trending Support Line

Credit: www.thinkorswim.com, ProphetCharts®

What is interesting about a clear uptrend is that you can draw a line connecting all the lowest points together as shown in the above chart. This line is known as a **'trending support line'**. This support line acts like a "psychological floor" that "supports" the price.

The moment the candles break below this line, buyers will rush in to push it up again. As long as the candles stay above this support line, it is pretty clear that the uptrend remains intact.

Many investors who buy a stock on an uptrend like to buy at the time when prices dip and "bounce off" this line (see Chart 3.7).

Chart 3.7: Buying a Dip on an Uptrend

Credit: www.thinkorswim.com, ProphetCharts®

Price Downtrends

When the market gets more and more pessimistic about a particular stock (or index), it is translated into a pattern known as a 'downtrend'.

A **downtrend** is characterized by a series of stock prices making lower high points and lower low points. On a downtrend, stock prices still go up and down. However, every time prices go up, they move down even lower subsequently.

Chart 3.8: Stock Price on Downtrend

Credit: www.chartnexus.com

When a stock is on a downtrend, it means that investors are getting more and more pessimistic. This causes downward price momentum that drives the stock lower and lower. This will keep happening until a major news development changes the direction of the trend.

As a rule, I never, ever buy a stock when it is on a downtrend. On a downtrend, you never know how low a stock can go. Remember that in the short term, markets are emotionally driven and prices can get driven down to illogical levels. Even if the stock of a good company seems cheap, it can get much cheaper in the short term. I prefer to let the stock bottom and buy it when it has reversed to a new uptrend.

"The stock has gone so low already, it cannot possibly go any lower" is a thought that has gotten many untrained investors into trouble!

Drawing a Trending Resistance Line

Similarly, on a clear downtrend, you can draw a line connecting all the highest points together as shown in the below chart. This line is known as a **'trending resistance line'**. This resistance line acts like a "psychological ceiling" that prevents the stock price from moving higher.

Chart 3.9: Stock Price on Downtrend with Trending Resistance

Credit: www.chartnexus.com

The moment the candles attempt to move above this line, sellers will rush in to push it down again. As long as the candles stay below this support line, it is pretty clear that the downtrend remains intact.

If you intend to 'short sell' ('short') a stock in order to profit from its decline (we'll talk more about this later), then the best time to do so would be when prices rally to hit this line and reverse back down again. By selling on these rallies on a downtrend, you maximize your profits of selling high and buying back much lower.

Identifying Changes in Trends

One of the secrets of being a successful investor is knowing how to identify a change in trend. When a stock's price is on a downtrend, you would want to wait for it to reverse to an uptrend before placing your buy order.

Many untrained investors make the mistake of jumping in too early when the stock price makes short rallies, only to find that the stock price plunges even lower subsequently. These short-term rallies are called **'bear traps'**.

Chart 3.10: American Express (AXP) 2008 – 2009

Credit: www.thinkorswim.com, ProphetCharts®

Is it possible to know when the stock price is going through a true change in trend instead of a bear trap? While there is no guaranteed method that works 100% of the time, there are strategies I use that indicate a very high probability of a change in trend. In this chapter, I will show you two of the simplest strategies that I use.

Similarly, if the stock you own is making profits on its uptrend, you must know when to sell to lock in profits once it reverses to a downtrend. During market crashes, downtrends can last for months and even years, causing significant losses to your portfolio.

In the chart below, you can see the S&P 500 index reversing to a downtrend in late 2007, when the US subprime mortgage crisis hit. It would have been a good time to sell and take your profits. Holding on to the stock on a downtrend would have resulted in all the profits made from 2003 to 2007 being wiped off by the crash. Next, I am going to show you how to identify these reversal signals.

Chart 3.11: S&P 500 Index 2003 – 2008

Credit: www.thinkorswim.com, ProphetCharts®

Using Moving Average Crossovers to Determine Change in Trend

One strategy I use to determine a change in trend is the **simple moving average (SMA)** crossover. A simple moving average (MA) is formed by computing the average closing price of a stock over a specific number of periods (e.g. days).

For example, a 50-day simple moving average (50 DMA) is computed by adding up the closing prices of the last 50 days and dividing the sum by 50. As its name implies, a moving average is an average that moves. Old data is dropped as new data comes available. This causes the average to move together with the stock prices.

Moving averages smooth the price data to form a trend following indicator. They do not predict price direction, but rather define the current trend direction. The chart below shows the 50 DMA line that can be drawn by any charting software.

Chart 3.12: Caterpillar (CAT) 50-Day Moving Average

Credit: www.thinkorswim.com, ProphetCharts®

Observing how two moving averages (a shorter time period and a longer time period) interact can help us determine a change in trend. Let's now insert a 150-day simple moving average (green) alongside the 50 DMA (blue).

Chart 3.13: Caterpillar (CAT) 50- & 150-Day Moving Average

Credit: www.thinkorswim.com, ProphetCharts®

Notice that during a downtrend, the green 150 DMA is always above the blue 50 DMA and both moving averages are sloping downward. An uptrend is signaled when the 50 DMA crosses above the 150 DMA and the moving averages start sloping upward (Point A).

By following this powerful signal, we would have only bought the stock at $35 (Point A), when it began its new uptrend. We would have avoided buying the stock when it was still on a downtrend (in 2008).

This powerful signal would also tell us when to sell the stock, thereby maximizing our profits. As long as the 50 DMA remains above the 150 DMA and moving averages are still sloping upward, we would stay invested in the stock and ride it all the way up. We would sell only when the uptrend reversed to a downtrend. This signal came in mid 2011 when the 50 DMA crossed below the 150 DMA and the two moving averages started to slope downward (Point B). We would have sold the stock at $90, making a 157% return on our investment!

Uptrend signal:
50 DMA crosses above the 150 DMA and
Both moving averages slope upward

Downtrend Signal:
50 DMA crosses below the 150 DMA and
Both moving averages slope downward

Take note that the 50 and 150 DMA crossover helps you to identify the medium and long-term trends of a stock. Shorter term moving averages can also be used to capture the shorter term trends. This is however beyond the scope of this book and covered during our live *Wealth Academy™* training/coaching sessions.

The 50/150 DMA Crossover Signal Would Have Helped You Avoid the Subprime Crash of 2008!

In October 2007, the US subprime mortgage crisis hit and the S&P 500 reversed to a downtrend, plunging 55% to a low of 650 points. Many untrained investors who did not know how to read the change in trend would have suffered a huge blow to their stock holdings.

Using the 50/150 DMA signal, many of my students were savvy enough to sell their stocks in late 2007 (when the 50 DMA crossed below the 150 DMA) and avoided the downtrend. Afterward, the 50/150 DMA crossed again in mid 2009, signaling a new uptrend! The ability to read trend changes doesn't just help you to make money, but it helps you to avoid potential losses as well.

Chart 3.14: S&P 500 2007 – 2010

Credit: www.thinkorswim.com, ProphetCharts®

Consolidation: The Sideways Trend

Besides uptrends and downtrends, stock prices also go through periods of **consolidation**. This means that the stock price moves sideway between an upper and a lower range. In the following chart, the stock price of Las Vegas Sands (LVS) is consolidating between $37 and $49.

This happens because the market is undecided on which direction (up or down) the stock should take. Consolidation patterns can take place for days, weeks or even months. However, the stock will ultimately break out of this consolidation pattern in either an upward (uptrend) or a downward (downtrend) direction.

As long as a stock is stuck within a consolidation pattern, there is no point in making an investment just yet. Even if the price rises, it will likely hit the upper price range (known as the 'resistance line') and reverse back down to the lower price range (known as the 'support line'). You have a better chance of making a profitable investment only when the stock price breaks out of this range.

However, short-term traders sometimes buy a stock when it bounces off the support line, hoping to make some quick profits before it hits the resistance line and comes back down again.

Chart 3.15: Price in Consolidation

Credit: www.thinkorswim.com, ProphetCharts®

Support Line

When you observe stock price charts, you will notice times when a stock's price repeatedly falls to a certain price level and cannot seem to fall below it. It is as if an invisible force field pushes it back upward. This price level is known as a **'support line'**.

These are psychological 'price floors' where buyers rush in to outnumber sellers and push the stock price up again. It is very important to understand where these support lines exist on a stock's price chart. It is also useful to note that stock prices do not always fall to the exact price level of the support line before bouncing back up. Sometimes, the price may move slightly below the support line before buying momentum emerges, as shown by the following chart.

Chart 3.16: Buying Momentum Emerging below Support Line

Credit: www.thinkorswim.com, ProphetCharts®

So how can you make use of support lines to make better investment decisions? Well, whenever a stock price falls to a support line and is unable to penetrate below it, buyers rush in, and this creates short-term upward (bullish) momentum. So, it may be useful to buy a stock when it bounces off a support line and catch the upward momentum. However, do note that if the moving averages do not confirm an uptrend yet, it is unlikely that the upward momentum will last for long. This is why people who buy a stock when it bounces off support are normally hoping for just short-term profits.

In the following chart, you can see a very strong support level at $17.20 for UOB's stock price. To draw a support line, connect the two or more lowest points of a stock's price. The more the support line is hit by the stock price, the stronger it is. In this case, UOB's stock price touches the same support line four times, as shown by the red circles.

Chart 3.17: Drawing a Support Line for UOB Stock

Credit: www.chartnexus.com

When a Stock Price Breaks a Support Line… Look out Below!

Another important pattern to note is that when a stock's price breaks below a support line and is unable to move back above it within the next few daily candles, downward selling pressure pushes the stock price even lower. This may lead to a new downtrend.

Chart 3.18: Stock Price Breaking Support Level

Credit: www.chartnexus.com

Many short-term traders hoping to profit from shorting a stock would actually start short selling when the stock price breaks below a significant support line. This adds further downward pressure on the stock price. As an investor, I usually sell a stock when it breaks below a significant support line and would only buy it back again when it hits the next support line below, and reverses back to an uptrend.

Resistance Lines

You will notice times when a stock's price repeatedly rises to a certain price level and cannot seem to move above it. Again, it is as if an invisible force field repels the price back downward. This price level is known as a '**resistance line**'.

These are psychological 'price ceilings' where sellers rush in to outnumber buyers and push the stock price down again. Again, it is very important to know where these resistance lines exist on a stock's price chart. The more the resistance line is hit by the price, the stronger the resistance becomes.

Chart 3.19: Drawing a Resistance Line for KB Home

Credit: www.thinkorswim.com, ProphetCharts®

As an investor, I never buy a stock when it is selling near a resistance line. This is because there is a high probability that the stock will rise a bit, hit that resistance level and fall back down again. When a stock price fails to break above an overhead resistance, it usually falls all the way back down again.

If a stock I have bought rises to a strong resistance level and is unable to break above it, I would usually sell to realize my profits. This is because there is a high probability that the downward momentum will drive the price down and cause my profits to evaporate!

If you look at the following charted example, I bought Google at $460 as it bounced off a strong support level at $450. When it climbed all the way up to the resistance line of $625 and could not break above it, I quickly sold to realize profits at $610. If I had not sold, all my profits would have been lost as the stock fell back down to $475 again. This is why observing resistance lines is so important.

Chart 3.20: Google Resistance Line

Credit: www.thinkorswim.com, ProphetCharts®

When a Stock Breaks a Strong Resistance Level, Get Ready for a Rally!

When a stock is finally able to break above a strong resistance line after past failed attempts, it is usually a sign of strong upward price momentum. This would be the best time to buy a stock, provided the company meets all the fundamental criteria.

Whenever a stock is able to break above a strong resistance line, buyers tend to rush in and push the stock much higher. A breakout above a strong resistance often leads to a new uptrend.

Chart 3.21: Walt Disney (DIS) Breakout

Credit: www.thinkorswim.com, ProphetCharts®

In the chart above, you can see that there was a strong resistance level at $34. The moment the stock was able to break above this level, the buying pressure drove the stock into a new uptrend. A great buying entry would have been at $35.

The Safest Point to Buy a Breakout

If you are looking to buy a good stock when it breaks out of a consolidation pattern, avoid buying immediately when the stock price first breaks above its resistance line (Point 1). There are times when the stock may signal a 'false breakout' only to fall back down to the consolidation channel.

Experienced investors/traders will wait for the stock to pull back (after a price advance, prices will often pull back) and ensure that the stock remains above the previous resistance line. If the previous resistance line is able to now support the stock price and the stock price continues its advance, it would be a safer time to make a buy entry and ride the stock up. Point 2 would be a safer buying entry point.

Chart 3.22: JP Morgan Breaks out of Consolidation

Credit: www.thinkorswim.com, ProphetCharts®

Many More Indicators

Using moving averages as well as support and resistance lines will help you better understand the emotions the market has toward a particular stock or market. This in turn will help you to better time your buy and sell decisions. I have found that simply using moving averages and support/resistance lines has been good enough in helping me achieve consistent profits as an investor.

As you read more books and attend more courses on technical analysis, you will find that there is a huge array of indicators that people use to help them read the emotions of the market. There are other trend following indicators like the MACD (moving average convergence divergence) and the directional movement index (DMI), as well as volatility indicators like the relative strength index (RSI), stochastics and Bollinger Bands that tell you if a stock is overbought or oversold. Many of these indicators are applicable for very short-term trading and not investing.

However, this does not mean that the more indicators you use, the more successful you will be as an investor. That is a classic mistake made by amateurs. Sometimes, using more indicators will only lead to conflicts in signals and a much lower success rate. The most successful investors/traders I know use only a few indicators very well to get the best results.

Probabilities, Not Certainties

No matter what strategy you use to identify the emotions and the trends in the market, always remember that it is never a <u>certainty</u>. The best indicators can only enhance your <u>probability</u> of success.

> Technical analysis helps you identify high probability outcomes but they are never 100% certain.

This is because the emotions of millions of people in the market can change because of a sudden news item that can never be predicted! For example, indicators may tell you to buy a stock because it has started on an uptrend or broken above a resistance line. However, if there is a sudden release of bad news (e.g. US GDP comes in worse than expected), the stock price may suddenly reverse back to a downtrend. Such things happen at times!

So, a buy signal from an indicator or a technical analysis strategy does not work 100% of the time. However, it increases the probability of the stock moving in the direction you want beyond random 50/50 chance (i.e. 55% – 70% probability of success).

Reliability and Risk Management

So, how do you make consistent profits if the strategy you use is not 100% reliable? The truth behind making profits from the stock market (or any kind of investment) is not about being right all the time. Just like in business or in life, you can never win all the time.

The secret is to make a lot more money when you are right and to lose only a bit when you are wrong. Even if you are right only 50% of the time, you can still make a lot of money if the profits you make far outweigh the losses that come from times when the technical indicators fail.

In order to achieve this, you have to practice **risk management**. Part of risk management involves cutting your losses when the indicator fails, so as to minimize your losses. Some people I know study the best technical indicators and yet end up losing money. This is because they did not manage their risks and cut their losses in time. As a result, their losses far outweighed their profits.

Placing Stop-Loss Orders

Whenever I make a buy decision based on technical indicators or breakouts, I always place a stop-loss order with my broker. I recognize that technical analysis is based on probability and there is always a chance that my desired outcome may fail.

A **stop-loss order** automatically sells the stock when it hits a predetermined stop-loss price that I set. This limits the loss from any of my losing investments. By following this strategy, I never allow any losing investment to wipe away the huge profits I make from my winning investments.

When buying a stock as it breaks out of a resistance price, it is always prudent to set a stop-loss order a one-candle length below the new support line (previously the resistance).

Let's see how you would use technical analysis successfully for Nike's stock (NKE). On 7 July 2011, Nike' stock price broke above the resistance line at $90. However, it turned out to be a false breakout. Within a week, the stock lost momentum and broke below the previous resistance (new support level) and fell to $77.50.

Chart 3.23: Nike (NKE) False and Successful Breakout

Credit: www.thinkorswim.com, ProphetCharts®

If you had practiced risk management, you would have bought NKE at $92.50 when it broke out but would have put a stop-loss at $89.40. Since the length of a candle is about $0.80 and the support price was at $90, a stop-loss at $90 - $0.80 = $89.20 would have been safe.

When the first breakout failed and the price fell back down, the stop-loss order would have been activated and you would have sold at $89.20, making a loss of $92.50 - $89.20 = $3.30 per share (4% loss).

Three months later in October, Nike broke out again. If you had bought in at $92.50, you would have enjoyed a huge profit gain to $112.50. That would have been a $20 profit (+21.6%). So, even though the breakout pattern worked 50% of the time, you would still have made a profit of $20 - $3.30 = $16.70 a share (+18% gain)!

Always remember that when you use technical analysis to time your entry into a stock, it is never a 100% certainty. It is only a probability (greater than 50%). As long as you cut your losses when the indicator/pattern fails, you will end up making much more than you lose.

FOUR
CHAPTER

ETFs: The Simplest Way to Profit from Investing

ETFs: The Simplest Way to Profit from Investing

CHAPTER **FOUR**

In Chapter 2, you learnt that while stock markets (represented by stock indexes) are volatile in the short term, they will always appreciate and reach higher highs over the long term.

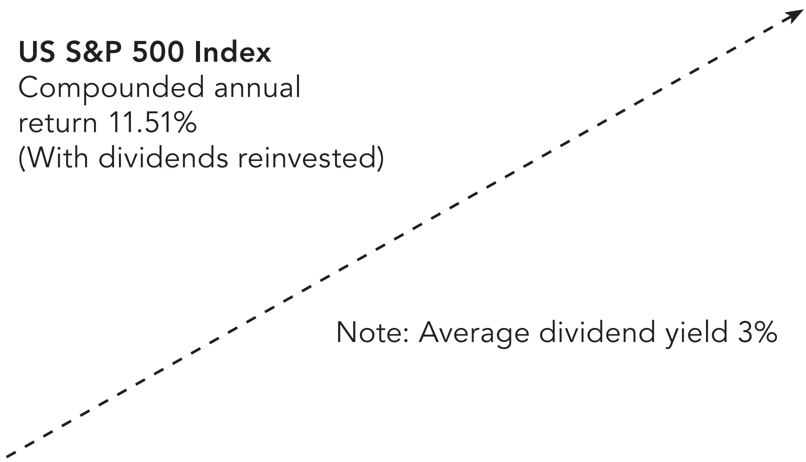
Why Stock Indexes Always Rise over Time

Inflation and population growth will always drive the prices of goods and services higher, resulting in companies generating higher dollar sales and profits. This will in turn lead to companies being worth more over time and their share prices increasing accordingly.

Another reason why stock indexes always rise over time is because they are composed of the largest and most successful companies in a market. The moment one of the companies in an index is no longer successful, it will be eventually be replaced by a larger and more successful company. For example, when American International Group (AIG) and General Motors (GM) got into financial trouble during the 2008 – 2009 recession, they were removed from the Dow Jones Industrial Average and replaced by Travelers Group and Cisco Systems.

Take a look again at the annual returns of the various stock market indexes over the last 30+ years.

Chart 4.1: S&P 500 Index 1980 - 2010



Credit: www.thinkorswim.com, ProphetCharts®

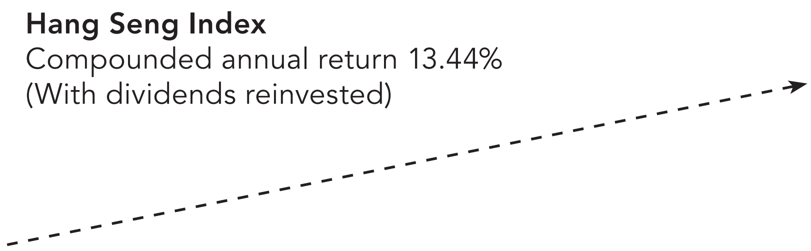
Chart 4.2: Straits Times Index 1980 – 2010

Singapore Straits Times Index
Compounded annual return 10.15%
(With dividends reinvested)

Note: Average dividend yield 4%

Credit: www.chartnexus.com

Chart 4.3: Hang Seng Index 1986 – 2010



Credit: www.yahoo.com/finance

On average, stock markets have appreciated at an annual compounded rate of return of 10% – 12% (including dividends reinvested) over the last 30 years. The best performing markets have been Jakarta's Jakarta Composite Index, India's Sensex Index, Hong Kong's Hang Seng Index and the United State's S&P 500 index. The returns you get from investing in these stock markets would far surpass the returns you get from investing in many other asset classes like bonds, real estate and bank deposits.

The Simplest Way to Profit from the Stock Market

If stock markets always rise over time and deliver relatively high returns, why doesn't everybody make money from their stock investments? Why are there people who have lost money investing in stocks and find them risky?

One reason is because many of these investors have invested in the stocks of poor-performing companies. Obviously, if you buy shares in companies that do not make consistent profits, they will decline in value. So, the key is to ensure that you only invest in the most successful companies that are available for sale on the stock market.

So, how do you identify the very best companies to invest in? This is something you are going to learn in Chapters 5 & 6. You are going to learn how to pick profitable companies by analyzing their financial reports and their growth prospects.

For investors who may not have the time or the inclination to study companies in detail, let me tell you the good news — you can easily profit from the stock market by just buying the entire stock market index. After all, the index already consists of the largest and most successful companies in the entire stock market. By simply buying the index, you can be certain that your investments will appreciate at an annual rate of 10% – 12% (with dividends reinvested) over the long term.

Buying the Index with Exchange-Traded Funds (ETFs)

So, how do you buy the entire index? Am I suggesting that you buy all 500 companies in the S&P 500 index or all 30 companies in the Straits Times Index? Of course not.

You can simply buy **Exchange-Traded Funds** (ETFs), which are designed to track the performance of an index. An ETF is an index fund that trades like any other stock on the stock exchange. When you buy a typical stock, you are buying a part of a publicly listed company. When you buy an ETF, you are actually buying a portion of many companies rolled into one.

Country-Specific ETFs You Can Invest In

There are hundreds of ETFs that are designed to track the performance of the different stock market indexes in various countries. For example, if you want to invest in the US S&P 500 index, you can buy shares of the SPDR S&P 500 ETF. By investing in this ETF, you are essentially investing in shares of the 500 largest and most successful companies in the US market.

Let's take a look at the most popular country-/market-specific ETFs that potentially offer you the best returns.

US Stock Market

Although the US government is currently facing a ballooning budget issue and anemic economic growth, its stock market is still home to the fastest growing and most successful companies in the world. Many of the brands that we use every day, like Google, Apple, Boeing, McDonald's, Coca-Cola, Microsoft, Citigroup and Kraft are listed on the US stock exchange.

Many multinational companies now derive more than half of their sales from outside of the US domestic market. Despite the recent subprime mortgage crisis, the US stock market has been one of the best-performing markets in the world, rising over 104% over the last four years 2009 – 2012.

You can invest in the growth of the most successful US companies by investing in ETFs that track US stock market indexes like the Dow Jones Industrial Average, the S&P 500 and the S&P MidCap 400. Let's take a closer look at these ETFs.

1) SPDR Dow Jones Industrial Average ETF (Ticker: DIA)

The SPDR Dow Jones Industrial Average ETF is designed to track the performance (before expenses) of the Dow Jones Industrial Average. Here are some quick facts:

3-year annualized return (2010 – 2012)	17.99%
Exchange	NYSE*
Expense ratio	0.18%
Dividend yield	2.43%
Fund manager	State Street Global Advisors www.spdrs.com

**NYSE: New York Stock Exchange*

2) SPDR S&P 500 ETF (Ticker: SPY)

The SPDR S&P 500 ETF is designed to track the performance (before expenses) of the S&P 500 index.

3-year annualized return (2010–2012)	16.21%
Exchange	NYSE
Expense ratio	0.1%
Dividend yield	1.98%
Fund manager	State Street Global Advisors www.spdrs.com

3) SPDR S&P MidCap 400 ETF (Ticker: MDY)

The SPDR S&P MidCap 400 ETF is designed to track the performance (before expenses) of the S&P MidCap 400 index. While the Dow Jones index comprises the 30 largest companies in the US market and the S&P 500 comprises the 500 largest companies, the S&P MidCap 400 is made up of the 400 most successful medium-sized companies in the US.

3-year annualized return (2010–2012)	18.93%
Exchange	NYSE
Expense ratio	0.25%
Dividend yield	0.99%
Fund manager	State Street Global Advisors www.spdrs.com

Comparing the Dow Jones, S&P 500 and S&P MidCap 400

Remember that the Dow Jones index comprises the 30 largest and most successful companies in the US market while the S&P 500 includes the largest 500 companies. Although these two indexes move very closely together, the Dow Jones tends to be slightly less volatile as compared to the S&P 500.

When the market is bullish, the S&P 500 tends to slightly outperform the Dow Jones. However, when markets go through a crisis, the Dow Jones tends to decline slightly less than the S&P 500. However, over the last 5 years, they have become a lot more correlated.

Chart 4.4: S&P 500 Versus Dow Jones ETF 2002 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

While the Dow Jones and the S&P 500 comprise only large companies (large cap), the S&P MidCap 400 is made up of the 400 most successful medium-sized companies. While mid cap companies may not be as dominant and financially strong as large caps, they have a lot higher growth potential. In fact, the S&P MidCap 400 ETF has outperformed the S&P 500 (and the Dow Jones) over the last 10 years! Take a look at the comparison chart on the next page.

Chart 4.5: S&P 400 (Green) Versus S&P 500 ETF (Black)

Credit: www.thinkorswim.com, ProphetCharts®

Singapore Stock Market

As of 2012, the Singapore stock market is one of the most undervalued markets in Asia and offers one of the greatest potential for appreciation (upside potential). It is also the politically and economically strongest market in Southeast Asia with a GDP growth rate of 7% – 14% over the last 5 years.

However, being a small, export-driven economy, Singapore's stocks are vulnerable to fluctuations in the global economy. You can ride on Singapore's growth by investing in the SPDR Straits Times Index ETF.

4) SPDR Straits Times Index ETF (Ticker: ES3)

The SPDR Straits Times Index ETF is designed to track the performance (before expenses) of the Straits Times Index.

3-year annualized return (2010–2012)	10.14%
Exchange	Singapore Exchange (SGX)
Expense ratio	0.30%
Dividend yield	2.69%
Fund manager	State Street Global Advisors www.spdrs.com

Chinese Stock Market

The Chinese stock market is certainly one that you cannot ignore. The Chinese economy is now the second largest behind the United States and boasts one of the strongest GDP growths in the world (7.2% in 2012). Although the Chinese economy has slowed down from 9% growth to 7% in 2012, it remains on track to eventually becoming the world's largest economy.

The Chinese stock market has been one of the best-performing markets up to 2008, when the US financial crisis and the subsequent European debt crisis hit. Fear of a China 'hard landing' coupled with government monetary tightening policies (to control inflation) has caused the Chinese stock market to decline from 2008 to 2012. As a result, Chinese stocks are currently much undervalued (as of 2012) and present a great investment opportunity for long-term investors.

You can gain exposure to Chinese stocks by investing in the Morgan Stanley China A Share ETF (ticker: CAF) or the SPDR S&P China ETF (ticker: GXC). The CAF comprises Chinese stocks listed on the Shanghai Stock Exchange and Shenzhen Stock Exchange in mainland China. The GXC invests mainly in Chinese stocks listed on the Hong Kong Stock Exchange.

5) Morgan Stanley China A Share ETF (Ticker: CAF)

The Morgan Stanley China A Share ETF is an active fund that invests at least 80% of its assets in A-shares of Chinese companies listed on the Shanghai and Shenzhen stock exchanges.

3-year annualized return (2010–2012	-3.04%
1-year annualized return (2012)	+30.79%
Exchange	NYSE
Expense ratio	2.13%
Dividend yield	2.07%
Fund manager	Morgan Stanley www.morganstanley.com

6) SPDR S&P China ETF (Ticker: GXC)

The SPDR S&P China ETF is designed to track the performance (before expenses) of the S&P/Citigroup BMI China Index.

3-year annualized return (2010–2012)	2.04%
1-year annualized return (2012)	21.26%
Exchange	NYSE
Expense ratio	0.59%
Dividend yield	2.4%
Fund manager	StateStreetGlobalAdvisors www.spdrs.com

From Chart 4.6, you can see that the CAF (blue line) has been more volatile than the GXC (black line) over the last 5 years. While the CAF performed better during the stock market rally up to late 2007, it has come down harder than the GXC over the last 4 years.

Chart 4.6: GXC Versus CAF

Credit: www.thinkorswim.com, ProphetCharts®

Other Country-Specific ETFs

Besides the US, Singapore and China, there are obviously many other country-specific indexes that you can invest in. Other great-performing markets would include Australia, Indonesia, Korea and Malaysia.

With the ongoing European debt crisis, you may want to look at the European stock index ETFs as an opportunity to ride the eventual recovery. However, do note that many European economies have even slower growth than the US, are even more debt-ridden and seem far from recovery at this stage. Here is a non-exhaustive list of other country-specific index ETFs you can look at.

Table 4.7: List of Country-Specific ETFs

Country/ Index	ETF	Exchange	Fund Manager
Indonesia/ Jakarta Composite Index	Market Vectors Indonesia Index ETF (IDX)	NYSE	Van Eck Global www.vaneck.com
Australia/ S&P/ ASX 200	SPDR S&P/ ASX 200 ETF (STW)	Australia Securities Exchange (ASX)	State Street Global Advisors www.spdrs.com.au
India/MSCI India Index	MSCI India Index ETF (INDA)	NYSE	iShares by BlackRock www.ishares.com
Malaysia/ Bursa Malaysia KLCI	FTSE BM KLCI ETF (0820EA)	Bursa Malaysia	AmInvestment Bank Group www.ambankgroup.com/sites/fbmklcietf
Europe/ MSCI Europe Index	Vanguard European ETF (VGK)	NYSE	The Vanguard Group www.vanguard.com
United Kingdom/ FTSE 100	iShares FTSE 100 ETF (ISF)	London Stock Exchange (LSE)	iShares by BlackRock www.ishares.com

You Can Become a Millionaire by Investing in the Index

As you can see, the best performing indexes have delivered annual compounded returns of 8% – 12% over the last 20 – 30 years. This means that if you invest in a portfolio of these index ETFs, you will achieve similar returns of your investments by holding them for the long term.

8% –12% returns may not seem really exciting, but it sure beats the meager 1% – 3% returns you get from bank deposits and 3% – 5% returns you get from bonds.

Did you know that a 10% annual rate of return would turn your savings into a million dollars, even if you earn an average income? Let's take a look at the math.

The average person earns $42,000 per year ($3,500 per month)
The average person works for 35 years throughout their career
Total amount earned = $42,000 × 35 years = $1,470,000

This means that as an average income earner, you would earn a grand total of $1.47 million in your lifetime. Unfortunately for most people, very little of that income would be left by the time they retire.

However, if you were to just save 10% of your income ($4,200) and invest this into index ETFs consistently every year for 35 years, how much would you end up with?

$4,200 invested annually for 35 years and grown at an annual compounded rate of return of 10% would accumulate to $1.25 million.

That is almost 85% of the total amount of income you earn in your entire career ($1.47 million)!

Obviously, if you earn an above-average income, you would be able to accumulate a much higher amount. The table below shows how much you would accumulate if you were to save 10% of your income and invest it into an index ETF.

Table 4.8: Accumulated Savings with Annual Return of 10%

Annual Income	Save 10%	Amount in 10 years	Amount in 20 years	Amount in 35 years
$42,000	$4,200/year	$73,630	$264,610	$1.25m
$72,000	$7,200/year	$126,224	$453,618	$2.15m
$120,000	$12,000/year	$210,374	$756,029	$3.58m
$200,000	$20,000/year	$350,623	$1.26m	$5.96m

Doubling Your Returns with Index ETFs

If you think that a 10% annual return is too low and that it will take too long to achieve your next million, you are right. If you could double your returns to an average of 20% a year, it would allow you to achieve your goals much faster! Take a look at the next table and look what a huge difference a 20% annual return will make.

Table 4.9: Accumulated Savings with Annual Return of 20%

Annual Income	Save 10%	Amount in 10 years	Amount in 20 years	Amount in 30 years
$42,000	$4,200/year	$130,831	$940,907	$5.96m
$72,000	$7,200/year	$224,283	$1.61m	$10.21m
$120,000	$12,000/year	$373,805	$2.69m	$17.01m
$200,000	$20,000/year	$623,008	$4.48m	$28.37m

How do you achieve a return that is double or more of the index return? There are two ways:

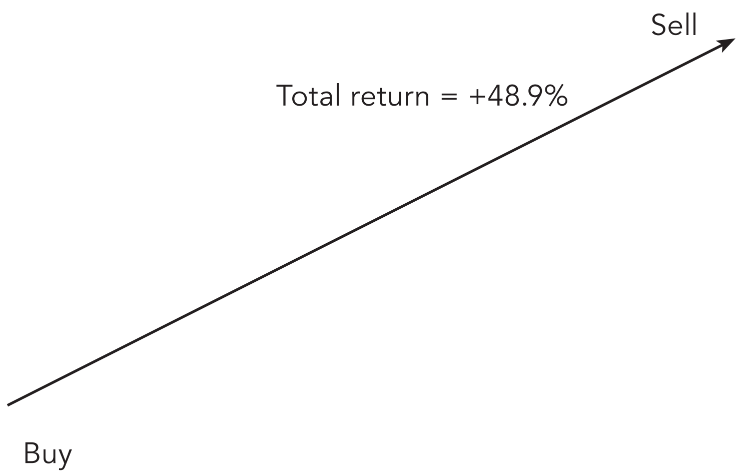
1) Invest in leveraged (ultra) ETFs that are designed to achieve returns that are double of the underlying index.

2) Instead of buying and holding the index through its ups and downs, you would achieve much higher returns if you buy when the index begins its uptrend and sell when the index reverses to a downtrend.

By using a trend following strategy, you would avoid having to hold the index through its loss making periods. You can make use of what you have learned in the earlier chapter to identify changes in trend.

For example, if you had bought and held the Kuala Lumpur Composite Index (KLCI) ETF from January 2007 (984 points) to August 2010 (1,465 points), you would have achieved a total return of 48.9%. During that time, you would have held on to unrealized losses during the January 2008 – April 2009 period. Take a look at the following chart.

Chart 4.10: Kuala Lumpur Composite Index 2007 – 2010



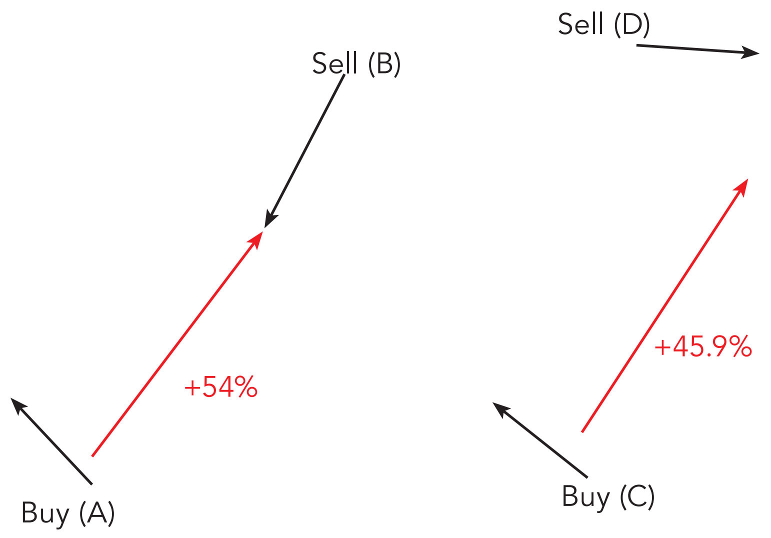
Credit: www.chartnexus.com

If you had invested only during the uptrend and sold when the index reversed to a downtrend, you would have achieved a much higher return of 73.8% during that same period. Take a look at Chart 4.11. Recall that in Chapter 3, you learned how to identify changes in trends using the moving average crossover indicators.

Using that technique, you would have bought the KLCI ETF at 984 points (Point A) and sold at 1259 points (Point B), when the 50 DMA crossed below the 150 DMA and both moving averages started sloping downward. This would have netted you a gain of 27.9%.

You would then have bought the index ETF again at 1,004 points (Point C), when the 50 DMA crossed above the 150 DMA and both moving averages started sloping upward. Holding this position to Point D would have netted you a gain of 45.9%. In total, you would have gained a return of 73.8% over that same period.

Chart 4.11: Kuala Lumpur Composite Index 2007 – 2010 (Buy and Sell Points)



Credit: www.chartnexus.com

Boosting Your Returns with Leveraged (Ultra) ETFs

Traditional ETFs are designed to track the performance of a particular index. A leveraged (ultra) ETF, on the other hand, uses financial derivatives and debt to amplify the returns of the underlying index by 2 to3 times. Leveraged ETFs are available for most US indexes, like the S&P 500 index and the Dow Jones index.

For example, the ProShares Ultra S&P500 (Ticker: SSO) is designed to double the daily performance (before expenses) of the S&P 500 index. For example, if the S&P 500 index rises by 1%, the SSO ETF will increase by 2%. Similarly, if the S&P 500 index falls by 1%, the SSO will double the losses to 2%.

How does this work? Well, the leveraged ETF may use financial derivatives like options to achieve the results. The ETF may also use debt to magnify your returns. If the ultra ETF aims to double your returns (and losses), it means that for every $1 of your money that it invests, it will borrow an additional $1 from the bank to invest as well. So, the debt-to-equity ratio is 1:1.

In this way, your $1 investment would result in an actual investment of $2. If the index goes up by 1%, your profit would be 1% × $2 = $0.02. $0.02 profit out of $1 you invested is actually a 2% rate of return!

Chart 4.12: S&P 500 Index Versus Ultra S&P500 ETF

Credit: www.thinkorswim.com, ProphetCharts®

Chart 4.12 shows you how the Ultra S&P500 ETF (SSO) doubles the performance of the S&P 500 index. If you are an investor who is looking to turbocharge your returns while being able to live with the increased volatility, then you can invest in leveraged ETFs. Below is a list of some popular leveraged ETFs. Many of them are managed by ProShares. You can read more about these leveraged ETFs at www.proshares.com. They are all listed on the US NYSE.

Leveraged ETF	Description	Ticker Symbol
Ultra Dow30	Double Dow Jones	DDM
Ultra S&P500	Double S&P 500	SSO
Ultra QQQ	Double NASDAQ-100	QLD
Ultra MidCap400	Double S&P MidCap 400	MVV
Ultra MSCI Europe	Double MSCI Europe Index	UPV
Ultra MSCI Emerging Markets	Double MSCI EM Index	EET

The Best Time to Buy and Sell Index ETFs

Now that you have a good idea about the kind of index ETFs you can invest in, you need to have a strategy of when to invest and when to sell. There are at least three different strategies you can choose to employ: 1) Buy and hold, 2) dollar cost averaging and 3) trend following. The approach you choose will depend on how much time you want to spend monitoring your investments, your tolerance for volatility and the returns you are seeking.

1) Buy and Hold Approach

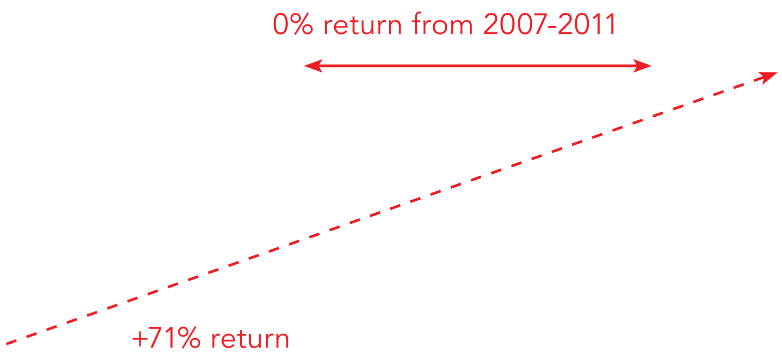
The buy and hold approach involves investing your money into an index ETF, "closing your eyes" and holding for the long term. As you have learned, the index will always trend higher over time. This approach is obviously the simplest to execute and will allow you to achieve the long-term returns of the index (i.e. 8% – 12% compounded annually).

The drawback of buying and holding is that it only works if you hold for the long term (10 – 30 years). In the short term, indexes can go into downtrends during crises and recessions. As a result, you may have to sit on unrealized losses for months and years during these bad periods. This method requires a lot of patience and the confidence that markets will rise over time.

From the following chart, you can see that if you had bought the S&P MidCap 400 index ETF (MDY) at the peak of the market cycle in 2007, you would have experienced a 55% plunge from late 2007 to early 2009. After holding the SPY from 2007 to 2011, you would have made a 0% return over that 4-year period.

So, the buy and hold method may lead to short-term losses or even breakeven periods, but will always become profitable if you hold long enough! From July 2004 to July 2012, your total return would be +71.14%.

Chart 4.13: S&P MidCap 400 Index ETF (MDY) 2004 – 2012



Credit: www.thinkorswim.com, ProphetCharts®

2) Dollar Cost Averaging

Dollar cost averaging (DCR) is another very simple-to-execute strategy that is safer than just 'buying and holding'. DCR involves buying a fixed dollar amount of ETF shares at regular intervals.

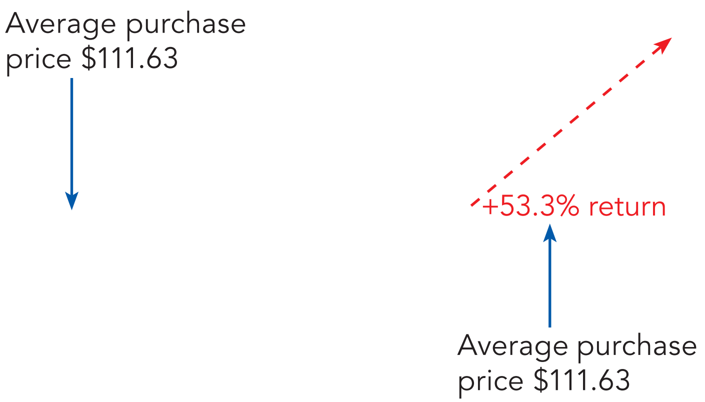
For example, you could invest a fixed amount of $5,000 every three months into the MDY ETF. No matter what happens to the index (whether it goes up or down), you consistently invest the same amount of money at the same regular interval.

Looking at Chart 4.13, when the ETF price is at a low point of $80.19 (November 2008), your $5,000 will buy you 62 shares. When the ETF price is at high point of $180 (May 2011), your

$5,000 will only buy you 27 shares. As a result, this technique will cause you to buy more shares when the ETF price is low and fewer shares when the ETF price is high. This ensures that you buy the ETF at the historical average (mean) price.

If you had used this technique on the MDY for 10 years from July 2004 to July 2012, you would have bought at an average price of $111.63. As of July 2012, this would translate to a total return of +53.3%.

Chart 4.14: S&P MidCap 400 Index ETF (MDY) 2004 – 2012



Credit: www.thinkorswim.com, ProphetCharts®

As you can see from Chart 4.14, the buy and hold method (+71%) has outperformed the dollar cost averaging (DCA) technique (+53.3%) for the last 8 years (2004 – 2012). This is because you would have initially bought in at a very low price back in 2002.

This is not to say that the buy and hold method always beats the DCA. During certain periods of time, the DCA method will deliver better returns. The DCA method will come out stronger at times when the index goes on a downtrend (e.g. between 2008 to 2009) or when it trends sideways (e.g. 2007 – 2011). The DCA method prevents you from buying the index at an all-time high point, only to see the value of your investments come crashing down to a low point.

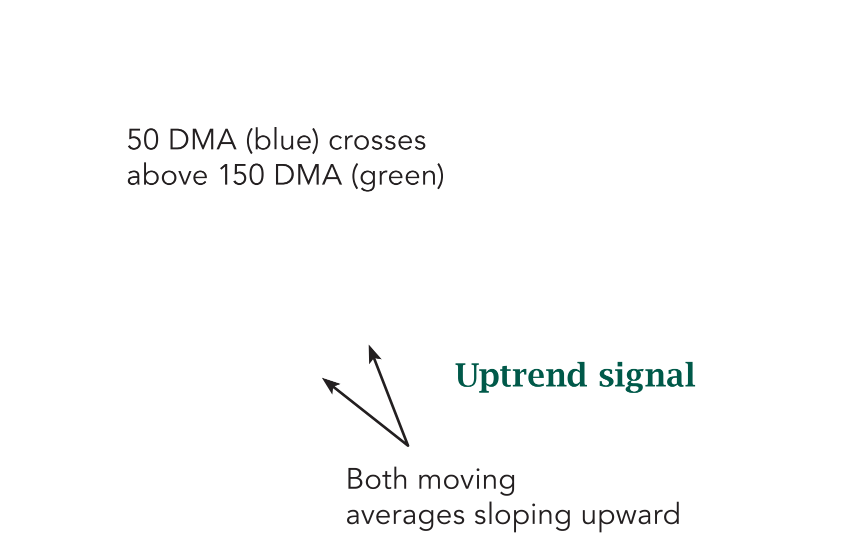
3) Trend Following

The trend following method requires you to spend time to monitor the trend of the index, but it produces the best returns over time. Trend following involves only buying the index ETF when it is on an uptrend and selling when it reverses to a downtrend.

Recall from the previous chapter that an uptrend is signaled when the 50 DMA is above the 150 DMA and both moving averages are sloping upward.

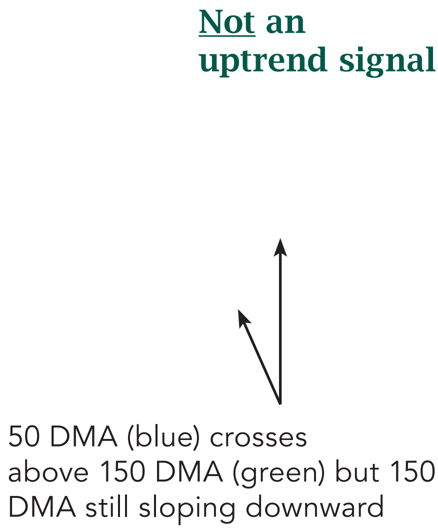
Note: Even if the 50 DMA crosses above the 150 DMA, it is <u>not</u> considered an uptrend yet if one of the moving averages is still sloping downward.

Chart 4.15: Uptrend Signal for S&P MidCap 400 Index ETF (MDY)



Credit: www.thinkorswim.com, ProphetCharts®

Chart 4.16: False Uptrend Signal for S&P MidCap 400 Index ETF

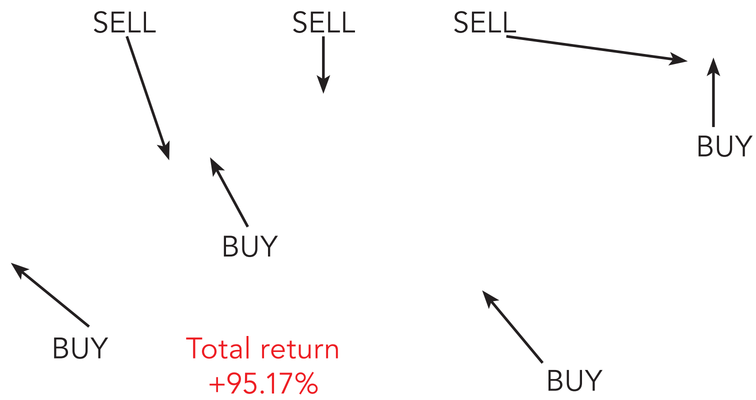


Credit: www.thinkorswim.com, ProphetCharts®

Similarly, a downtrend is signaled when the 50 DMA crosses below the 150 DMA and both moving averages slope downward.

Note: Even if the 50 DMA crosses below the 150 DMA, it is not considered a downtrend if the moving averages are still sloping upward.

Chart 4.17: S&P MidCap 400 Index ETF (MDY) 2004 – 2012



Credit: www.thinkorswim.com, ProphetCharts®

Look at Chart 4.17. Using this trend following method, you would have had 4 buy signals and 3 sell signals in the last 8 years.

Nov 2004 Buy 102.4,	Jun 2006 Sell 129.3	Profit 26.3%
Nov 2006 Buy 133.6,	Nov 2007 Sell 148.2	Profit 10.9%
May 2008 Buy 98.8,	Aug 2011 Sell 155.68	Profit 57.57%
Jan 2012 Buy 170.45,	Jul 2012 End 171.14	Profit 0.40%

Total return = +95.17%

Although no method can tell you when to buy at the absolute bottom and when to sell at the absolute top, this trend indicator tells you when to enter at the beginning of an uptrend and when to exit at the beginning of a major downtrend. As you can see, it also beats the passive buy and hold approach.

4) Buying and Selling Based on Market Cycle

As an investor in the index, it is also important to know which phase of the stock market cycle you are at. Stock markets do not keep going up forever and neither do they keep going down. They move in cycles of booms and busts. As an intelligent investor, you want to be investing when the stock market is near the bottom of the cycle (when prices are low) and to start selling for profits when the market is at the top of the cycle (when prices are high).

Unfortunately, untrained and uninformed investors do the complete opposite! They buy when stock prices are high and sell when stock prices are low. Buying high and selling low lead to losses and not profits. Why does this happen? It is because many people buy and sell stocks based on emotions and not based on logic. They buy when the mood in the market is optimistic and sell when the mood turns to fear and panic. Let’s take a look at the different emotions exhibited during different phases in the market cycle.

Figure 4.18: Psychology of a Market Cycle

Starting from the left of the chart:

The Beginning of a New Uptrend

When the stock market starts climbing from its bottom, most people are usually skeptical and believe that prices will only fall back down (disbelief). As stock prices continue to climb, people start to get hopeful that it could be the start of a new rally. However, there is still a lot of fear and uncertainty in the market at this time and most people will adopt a 'wait and see' attitude.

This is, however, the point of maximum opportunity (when stock prices are cheap and the market starts its new uptrend). This is when professionals like myself will start loading up on shares! In the words of Warren Buffett, "Be greedy when others are fearful."

As the stock market continues its bull run and early professional investors start making money, amateurs will start believing that they can get rich too. Belief then turns to excitement and as more people start buying, the surge in demand will send stock prices higher and higher.

Markets Reach the Top

You know that the market is near the top when everyone around you starts talking about shares and how easy it is to make money. This is the point of maximum optimism when people think that prices will keep going up forever. While the untrained masses pour their life savings into stocks at this point hoping to get rich quick, professional investors like myself recognize that this is the point of maximum risk. This is the time we will start selling our shares and locking in our profits. We know that when everyone is greedy, it means that stocks are overpriced and due for a big bust.

Markets Start a New Downtrend

As sure as night follows day, stock prices will begin to fall from their peak and enter a 'bear market' or downtrend. Unaware people will buy more shares, hoping to buy shares at cheaper prices (averaging down). To their horror, share prices will continue falling even lower. Anxiety will then turn to fear, denial, hopelessness and eventual panic (" I am going to lose everything!"). All these negative emotions will cause more and more people to sell, sending share prices all the way back down. Smart investors, on the other hand, will stay away from the market, knowing to never buy when the market is on a vicious downtrend.

Markets Hit the Bottom

You know that the market has reached the bottom when the general public gets extremely negative about the stock market. They get depressed and angry and vow that they will never invest again! Ironically, this is the point of maximum opportunity and the time that professional investors like myself will start to buy stocks again at cheap prices. Sure enough, the stock markets will begin to start a new uptrend and the cycle continues.

Using Index PE Ratio to Read Market Cycles

Surely, you cannot be expected to read market cycles by just reading the emotional expressions on people's faces. A more accurate method I use to pinpoint which phase of the stock market cycle I am in is the index PE ratio (price-to-earnings ratio).

When the stock market is at the top of its cycle, stock prices are very high, relative to the earnings reported by the underlying companies. This causes the index PE ratio to be high. Thus, a high index PE ratio is an indication of an overvalued and expensive stock market.

When the stock market is at the bottom of its cycle, stock prices are very low, relative to companies' earnings. This drives the index PE ratio to a low level. Thus, a low index PE ratio signals an undervalued and cheap market.

So, how high is high and how low is low? Take a look at the index PE ratio of the S&P 500 index (US market) for the last 136 years from the chart below. You can see that when markets crashed to the bottom, they hit an all-time low PE ratio of 5. When markets rallied to the top of their cycle, they tended to reach a PE ratio of 25 before coming back down again. The year 2000 was an exceptional period when the PE ratio reached an all-time high of 46.71, before the bubble burst and prices adjusted back down again. Throughout history, you can see that the median PE ratio has been 15.

Figure 4.19: S&P 500 Index PE Ratio Jan 1871 – Nov 2007[1]

Credit: www.politicalcalculations.blogspot.sg

In other words, when the PE ratio of the index is at 15, the stock market is at the center of its cycle where stocks are fairly priced. As the PE ratio moves above 15, the market gets more and more overvalued until it reaches a historical average high of 25. When

[1] "The Price/Earnings Ratio", Political Calculations, accessed March 20, 2013, http://www.politicalcalculations.blogspot.sg.

the PE ratio moves below 15, it means that the stock market is getting more undervalued until it finally bottoms at a PE of 5.

As an intelligent investor, you want to avoid buying stocks when the index PE ratio gets above 23 – 25. This tells you that the market is reaching its top.

Is the same true for other stock markets? Below is a list of the median PE ratios of various stock market indexes. Again, the median PE ratio signals the center of their market cycles.

Index	**Median PE ratio (2000–2010)**
Singapore Straits Times Index	13.65
Hong Kong Hang Seng Index	13.4
Kuala Lumpur Composite Index	14.1
Shanghai Composite Index	27.3
India Nifty Index	13.3
Jakarta Composite Index	12.3
London FTSE 100 Index	19.15

You can get the current PE ratio of any index quite easily from websites like www.bloomberg.com. At the time of my writing (August 2012), the PE ratio of the S&P 500 index is 13.98, signaling that the S&P 500 is still undervalued with a lot more potential for gains ahead.

Credit: www.bloomberg.com (accessed in August 2012)

However, Asian markets like the Shanghai Composite Index, Hong Kong Hang Seng Index and Singapore Straits Times Index are even more undervalued at this time. Their PE ratios are 11.45, 9.55 and 12.24 respectively. This makes these markets a great investment opportunity at this point in time.

Surprise! You Can Beat the Pros

There you have it! By buying and selling index ETFs based on analyzing their trends and PE ratios, you will be able to get even better returns than just buying and holding the index over the long term. You will even get much better returns than investing your money into a professionally managed mutual fund or unit trust.

Many people are amazed at how they can get better results compared to professional fund managers who have years more experience and access to even more analytical tools and data. So, why don't these professional fund managers, who manage hundreds of millions of dollars, do what I just taught you? The simple reason is because they can't! Here are the reasons why.

Unlike us, large mutual funds cannot sell all their stocks when a market goes into downtrend and liquidate everything into cash. They have certain restrictions that require them to stay invested and keep only a certain portion (10% – 20%) in cash. As a result, they will see the value of their portfolio fall 10% – 50% during steep downturns.

At the same time, they hold such large portions of shares (millions worth) that if they sell, it will cause the stock prices to fall even further! As small investors (with less than a million dollars per stock), we can happily buy and sell without moving the stock price at all. Thus, we enjoy the flexibility that they don't.

Finally, when you invest your money into a fund and have professionals manage it for you, you have to pay an annual management fee of 1% – 3% whether you make money or not. 1% – 3% per year of expenses means 1% – 3% lower returns for you! This would make a very big difference to your net worth over time. This is why it makes sense to invest by yourself once you have the necessary skills.

Now that you have the knowledge of how to invest in index ETFs of different markets, it is time to learn how to invest in individual stocks of companies that will outperform the market averages. I will see you in the next chapter.

FIVE
CHAPTER

How to Pick Stocks of Winning Companies

How to Pick Stocks of Winning Companies

CHAPTER**FIVE**

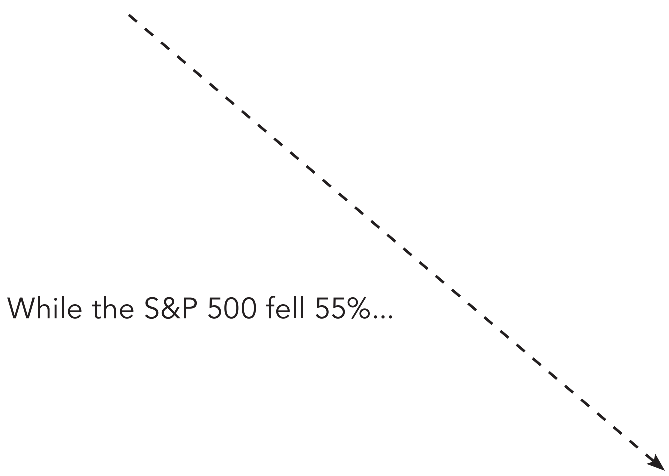
In the last chapter, you learned how to invest profitably in index ETFs. In this chapter, I am going to bring your investing skills to the next level by showing you how to achieve much higher returns by investing in stocks of companies that outperform the market index.

When you invest in an index ETF, it is like buying a music album compilation of many songs. However, not all the songs may be hits or songs that you want to listen to. Similarly, not all the stocks within an index are worth investing in at a particular point in time. They may be unprofitable, overpriced or on a downtrend. To be a successful investor, you must learn how to pick individual company stocks that make you a lot more money as compared to buying a whole bunch of companies where the good and bad stocks are all mixed together. You have to learn how to pick the song singles that are hits right now.

Winning Stocks Beat the Index

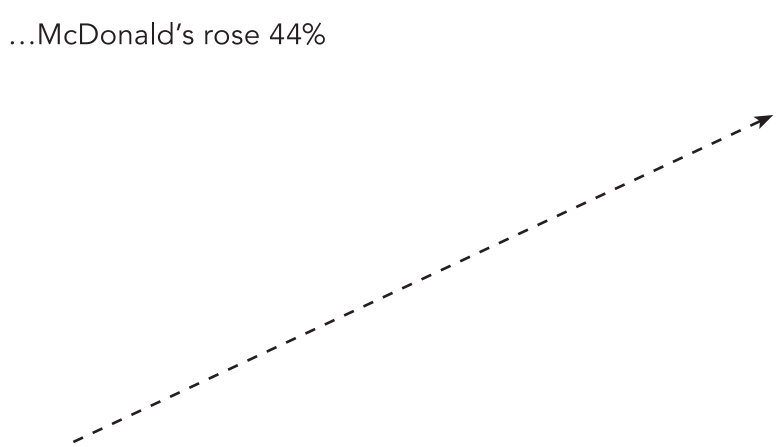
Even during a recession, when the index is on a downtrend, the savvy investor will know how to pick winning stocks that continue to make him money. During the US subprime financial crisis (January 2007 – March 2009), the S&P 500 index declined 55%. However, winning stocks like McDonald's (MCD) advanced 44% during that same period.

Chart 5.1: S&P 500 Index (Jan 2007 – Mar 2009)



Credit: www.thinkorswim.com, ProphetCharts®

Chart 5.2: McDonald's (MCD) (Jan 2007 – Mar 2009)



Credit: www.thinkorswim.com, ProphetCharts®

So, no matter how bad the whole market gets, there will always be individual company stocks that shine! Wouldn't you like to learn how to pick great stocks that are able to keep rising, even as the rest of the market sinks?

Philosophy of Successful Stock Investing

The philosophy behind successful stock investing involves three major steps. They are: 1) identifying great businesses, 2) investing when the stock price is undervalued and on an uptrend, and 3) selling for profits when the stock price reverses to a downtrend.

Step 1: Identify Great Businesses

Always remember that when you buy a stock, you are not buying a lottery ticket. You are actually buying a part-ownership of a business. If you want the value of your shares to increase over time, you must identify and invest only in great businesses. To do so, you must understand the business model of the company you are buying.

So, what is a great business? A great business is one that is able to increase its sales and profits consistently over the long term. This way, we are confident that the company's value and share price will also increase consistently over time. The only way it can achieve this is when it has a strong competitive advantage that prevents competitors from taking away its customers and market share.

A great business must also be financially strong enough to withstand any recession or downturn in the economy. Less than 10% of companies in the world qualify as great businesses. This includes companies like Caterpillar, IBM, McDonald's, Johnson & Johnson, Boeing and Coca-Cola. To be a successful investor, you should only invest in these high quality companies and stay away from poor-performing companies that are losing money or delivering inconsistent profits. You should also stay away from financially weak companies that have too much debt and can easily go bankrupt during a prolonged recession.

In the latter part of this chapter, you are going to learn specifically how to select these best-of-breed companies.

Step 2: Invest When Stock Price Is Undervalued and on Uptrend
Just because you have identified a great business does not mean that you should buy its stock right away. Great businesses usually sell at high stock prices (since everybody wants a piece of it).

Buying stocks is like buying any other item at a departmental store. Just because you spot a great-looking jacket at the store does not make it a good buy. The best time to make your purchase would be during a "great clearance sale", when you get a big discount off the fair price.

Similarly, you should only buy a great company's stock when it is selling at a price that is below its **intrinsic value**. The intrinsic value of a stock is the actual value of the stock, based on its profit-making ability. You will learn how to calculate this figure in the next chapter. When a stock's price is selling below its intrinsic value, it means that it has the potential to appreciate to its true value!

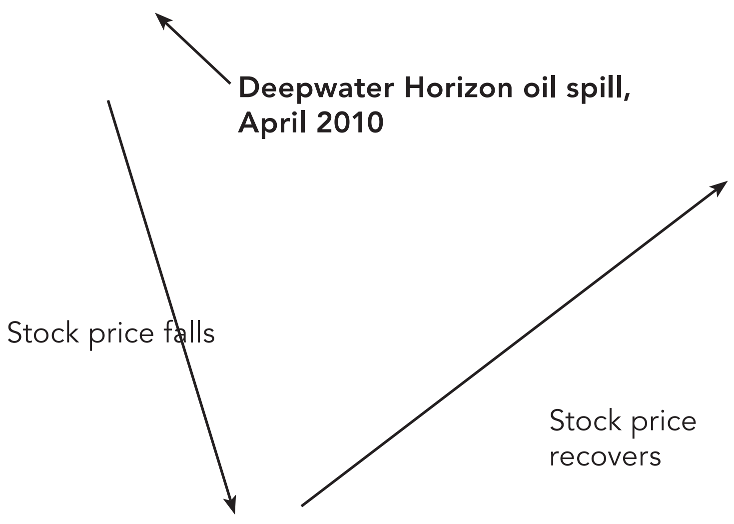
Why and When Does a Great Stock Sell at a Cheap Price?
No matter how great a company is, it is not immune to bad news that can cause a temporary fall in its stock price. For example, the company may report lower-than-expected profits, or it may be affected by a strike, a new product failure or even the bad results of a competitor. Sometimes, a company's stock can get hit because of fears of a recession in the whole global economy or panic from wars and disasters.

It is under these circumstances that the irrational short-term oriented market will panic and sell the stock until its price falls way below its intrinsic value. The smart value investor, knowing the true value of the stock, will buy as much as he can at such times, thereby getting a huge "discount". He knows that the bad news will soon be over, market confidence will return and the stock price will eventually recover to its true value. This is when very substantial returns are made for the investor who is patient and confident in his purchase. Here are a few examples.

British Petroleum Oil Spill Disaster

British Petroleum's (BP) stock price fell 55% when the BP-operated oil well in Deepwater Horizon exploded on 20 April 2010. As a result, BP's share price plunged from $55 to a low of $24.60, way below the stock's intrinsic value of $50. That made it a great buying opportunity!

Chart 5.3: British Petroleum (BP) (2010 – 2011)

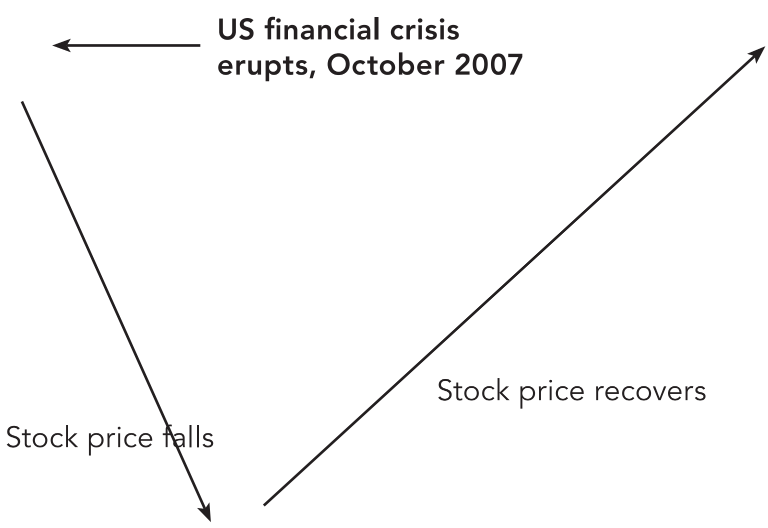


Credit: www.thinkorswim.com, ProphetCharts®

American Express (AXP) Hit by US Subprime Financial Crisis

In October 2007, when the US financial crisis erupted, the American Express (AXP) stock price fell 85% from $57 to $9, giving smart investors like myself the opportunity to buy great financial stocks at huge discounts.

Chart 5.4: American Express (AXP) (2007 – 2012)



Credit: www.thinkorswim.com, ProphetCharts®

Nike (NKE) Falls on Lower-than-Expected Earnings

Listed companies report their financial performance every quarter. Often, when a company reports sales and profits that are lower than what was expected by analysts, the stock price falls. If you believe that it is a great company that just had a temporary "miss", you would get the great opportunity to buy at a discount.

In March 2011, Nike reported lower-than-expected earnings for the quarter, resulting in a drop in the stock price from $88 to $73. This gave the smart investor to buy Nike at an undervalued price before the stock recovered and powered even higher to $95 in a few months.

Chart 5.5: Nike (NKE) Misses Earnings and Recovers

Credit: www.thinkorswim.com, ProphetCharts®

The risk in buying a company's stock when it falls because of bad news is that it may go much lower before the price starts to recover. It is therefore important to buy an undervalued stock only when it has reversed to an uptrend. There is an old Wall Street saying that goes, "Never attempt to catch a falling knife."

For example, when the American Express (AXP) stock fell in October 2007 from the fallout of the financial crisis, there was no telling how low it could go. Although AXP's intrinsic value was $50 and $35 seemed really cheap, the stock got even cheaper as it plunged to $20, $15 and subsequently to $9! In a market panic where fear takes over investors' logic, there is no telling how low a stock can go.

This is why I would only buy a stock when it reverses from a downtrend to a new uptrend. It was impossible to tell where the bottom for AXP was and hence impossible to buy at the bottom (about $9). Although I only started investing at about $22, when the 50 DMA crossed above the 150 DMA, I still made a nice 159% profit as the stock rose back to about $57 in the next few years.

Chart 5.6: American Express (AXP) Uptrend Signal

Credit: www.thinkorswim.com, ProphetCharts®

Step 3: Sell for Profits When Stock Price Reverses to Downtrend

Buying a great company at a low price is only half of the equation. Knowing when to sell a stock to lock in your profits is the other half.

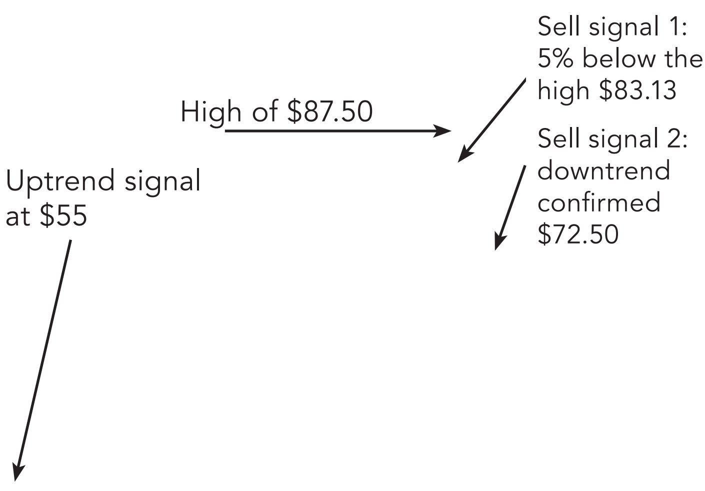
Although a great company will always continue to appreciate over the long term, the stock price will not go up in a straight line. Future recessions, downturns and company problems may cause the stock price to reverse to another downtrend before going higher.

You must know when to sell a stock and lock in the maximum profits before the stock falls and wipes out your unrealized hard-earned profits. If the company is still fundamentally strong, you can always buy back its stocks at an even lower price later on.

Take the example of Exxon Mobil (XOM). XOM is the strongest and most profitable oil company in the world. If you had bought the stock when it was undervalued and on an uptrend at $55, you would have gained +50% as it powered to $87.50 in 2 years.

However, if you did not sell when it reversed to a downtrend in May 2008, half your profits would have been wiped out! This is why knowing when to sell is even more important than knowing when to buy.

Chart 5.7: Exxon Mobil (XOM) Uptrend and Correction



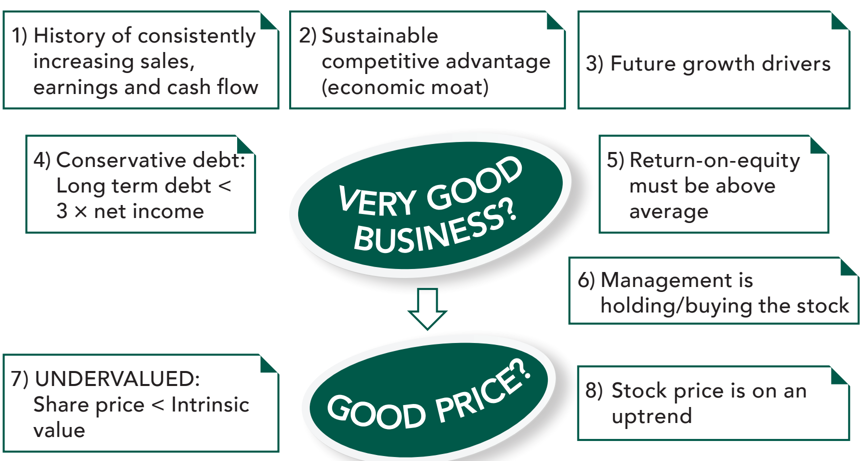
Credit: www.thinkorswim.com, ProphetCharts®

In Chapter 6, I will share with you more exit rules that I use to minimize my losses and maximize my profits. Instead of waiting for a confirmed downtrend to sell, I also follow the rule of selling a stock when it falls 5% – 8% below its recent high. This is a great technique for protecting profits. In the case of XOM, it reached a high of $87.50. By selling when it fell to $83.13 (5% below the high), I would have protected my profits before the stock plunged to $60 thereafter.

Eight Criteria for Selecting Winning Stocks

So, how do you go about finding great businesses selling at a good price and ready to appreciate? Well, there are altogether eight criteria to help you screen for these hidden gems.

Do bear in mind that in order to distinguish a great company from a poor-performing one, you must learn some basic accounting and financial concepts, which is the language of business. You must learn how to read a company's **income statement, balance sheet and statement of cash flows**. These three report cards tell you everything you need to know about how financially strong a company is and how good it is at making money. If you have little or no basic knowledge on this, I highly suggest you read my earlier book *Secrets of Self-Made Millionaires* where I teach the basics of accounting concepts. Now, let's begin by looking at an overview of the eight criteria.



The first 6 criteria are used to determine if the stock you are investing in is a great business that will grow in value over time. The 7th and 8th criteria are used to determine if the price is right and if it is the best time to buy the stock. Let's look at each of these criteria carefully by using Yum! Brands (YUM) as our case study.

Yum! Brands, Inc. (Ticker symbol: YUM) is a quick service restaurant company that owns 37,000 units in more than 120 countries and territories. The company operates through the concept brands of KFC, Pizza Hut, Long John Silver's, A&W and Taco Bell.

Criterion #1: History of Consistently Increasing Sales, Earnings and Cash Flow

** Note that 'earnings', 'net income' and 'profits' are used interchangeably, while 'sales' and 'revenue' are used interchangeably*

A company's value and stock price is basically determined by how much profit it makes and how much profit it is expected to make in the future. The higher a company's earnings and future earnings growth, the more valuable its shares!

The first way to determine if a company will be able to consistently increase its earnings is to look at its track record. If the company shows a history of consistently increasing sales and earnings over the last five years at least, especially during periods of recession, then there is a high chance it will be able to continue its performance.

If a company's past earnings show consistency, then future earnings will be more predictable to forecast with confidence. For example, look at General Motors and Johnson & Johnson's earnings (in green) and price chart (in black). General Motors' past earnings are too erratic to predict with certainty. However, Johnson & Johnson's earnings can be forecasted with a lot more confidence.

Chart 5.8: Stock Price and Earnings Chart

Credit: www.corporateinformation.com

Besides ensuring that earnings have been increasing consistently, it is also important to verify that sales revenue has also been increasing. While earnings can be creatively manipulated by accountants (this is unfortunately very common), sales cannot be changed. If a company shows earnings increasing with a concurrent stagnation or drop in sales, it sometimes means that the company is not really doing better but is cutting expenses.

Finally, it is also important to ensure that the company's operating cash flow has also been increasing consistently. Operating cash flow is the actual amount of cash that comes into a company as a result of its business operations. Sometimes, a company can have increasing sales and profits, but with declining cash flow. This could be due to the company being inefficient at collecting money that is owed to them. A profitable company that runs out of cash will also soon collapse.

Where Do I Find This Information?

Sales, earnings and cash flow can be easily found by running through the annual reports of the companies you are researching on. Just go to the section under 'income statement' (also known as 'profit & loss statement') to check sales and earnings information and go to the section under 'statement of cash flows' to look at the company's operating cash flow (also known as 'net cash from operations').

Currently, you can read a company's entire history of annual reports for free on the Internet on websites such as www.annualreportservice.com (for US companies) or www.sgx.com (for Singapore companies). Alternatively, just go to financial research websites like www.google.com/finance or www.morningstar.com where you can read a company's entire history of financial statements for free.

Figure 5.9: Yum! Brands Income Statement

Check sales revenue

Operating income	1,005	1,059	1,155	1,153	1,262	1,357	1,506	1,590	1,769	1,815	2,113
Interest Expense	172	173	129	127	154	166	253	212	195	184	177
Other income (expense)	25	—	—	—	—	—	27	18	20	28	24
Income before taxes	858	886	1,026	1,026	1,108	1,191	1,280	1,396	1,594	1,659	1,960
Provision for income t...	275	268	286	264	284	282	316	313	416	324	420
Other income	—	—	—	—	—	—	—	(12)	(20)	(16)	(12)
Net income from contin...	583	618	740	762	824	909	964	1,071	1,158	1,319	1,528
Cumulative effect of a...	—	(1)	—	—	—	—	—	—	—	—	—
Net income	583	617	740	762	824	909	964	1,071	1,158	1,319	1,528

Check net income
(i.e. earnings or profits)

2012 net income
is $1,528 million
(TTM) - trailing
12 months

Credit: www.morningstar.com

As you can see from the income statement from Figure 5.9, Yum! Brands has seen consistent sales revenue and net income (i.e. earnings) growth over the last 10 years. Now, let's look at its 'cash flow from operations' from its 'statement of cash flows' in Figure 5.10. Again, you can read that 'cash flow from operations' has consistently increased from $1,088 million to $2,171 million over the last 10 years.

Figure 5.10: Yum! Brands Statement of Cash Flows

Fiscal year ends in December USD in Million except per share data	2002-12	2003-12	2004-12	2005-12	2006-12	2007-12	2008-12	2009-12	2010-12	2011-12	TTM
▼ Cash Flows From Operat...											
Net income	583	617	740	762	824	909	964	1,083	1,178	1,335	1,540
Depreciation & amortiz...	370	401	448	469	479	542	556	580	589	628	638
Investment/asset impai...	—	—	—	—	—	—	43	103	47	135	52
Investments losses (ga...	—	—	—	—	—	—	41	—	—	—	—
Deferred income taxes	21	(23)	142	(101)	(30)	(95)	1	72	(110)	(137)	(99)
Stock based compensati...	—	—	—	—	—	—	59	56	47	59	56
Accounts receivable	—	—	—	—	—	—	(6)	—	—	(39)	(32)
Inventory	11	(1)	(7)	(4)	(3)	(31)	(8)	27	(68)	(75)	(81)
Prepaid expenses	19	—	(5)	78	(33)	(6)	4	(7)	61	(25)	(11)
Accounts payable	—	—	—	—	—	—	18	—	—	144	97
Income taxes payable	—	—	—	—	—	—	39	(95)	104	109	107
Other working capital	54	66	(190)	47	(12)	249	66	(59)	49	101	137
Other non-cash items	30	(7)	3	21	77	(1)	(256)	(356)	71	(65)	(233)
Net cash provided by o...	**1,088**	**1,053**	**1,131**	**1,272**	**1,302**	**1,567**	**1,521**	**1,404**	**1,968**	**2,170**	**2,171**

Cash flow from operations

Cash flow from operations $2,171 million in 2012 (TTM) - trailing 12 months

Credit: www.morningstar.com

Criterion #2: Sustainable Competitive Advantage

Although a company may have been able to increase its earnings in the past, there is no guarantee that it can continue to do so in the future. New competitors could enter and seize market share, or cause price drops, forcing the company to experience lower sales and earnings.

So, what will prevent this from happening? What can ensure that competitors will not be able to capture customers, even if they lower their prices? The answer is **sustainable competitive advantage**.

Let me give you an example. What allows Nike to sell more and more shoes every year, allowing it to consistently increase its earnings? Why can't competitors capture all of Nike's customers by offering a cheaper shoe? Even if you could invent a better shoe called 'Niko', could you take away all of Nike's customers? Highly unlikely. Why? The answer is because Nike's brand name gives it competitive advantage.

People buy Nike because of loyalty to the brand and the powerful feelings that the famous swoosh logo conveys! And sure enough, this competitive advantage it has against other shoe manufacturers will be sustained for many years to come, protecting it from any rivals. This is known as sustainable competitive advantage. Like a wide moat around a castle, it protects the company's future profits from invaders. This is why companies like Nike are also known to have a **wide economic moat**.

However, a powerful brand name is not the only thing that gives a company sustainable competitive advantage. Being a large company with huge 'economies of scale' also provides a business with a wide economic moat. For example, it is very difficult for any competitor to compete with Walmart (largest US retailer) or Amazon.com (largest internet retailer). Due to their massive size, they are able to buy millions of dollars worth of goods at whopping discounts, allowing them to price their items below anybody else.

Being a market leader is also a powerful competitive advantage. For example, Visa is so widely used as the number one credit card that almost all stores must accept it and almost every credit card user has to carry it. It would be almost impossible for anybody to start a new credit card and take away a huge chunk of VISA's business.

As a market leader, eBay's impenetrable moat comes from the fact that it has over 100 million registered users worldwide and has 10 million transactions per day. It is the place to go if you want to find the best prices to buy and sell products online. No other site with all the advertising or money in the world can ever compete.

Sometimes, a company's sustainable competitive advantage could be in the form of a special formula, technology or a patent they own. Pharmaceutical companies are able to continually make huge profits because they own patents on specific drugs (e.g. Viagra, Panadol) that no other company can legally copy and manufacture. When you invest in a company that has strong sustainable competitive advantage that protects itself against competitors and allows it to retain and build its customer base, you can predict with certainty that earnings and stock value will continue to increase.

In general, a company's sustainable competitive advantage can come from:

a. A strong brand (e.g. Coca-Cola, Nike, Pizza Hut, Procter & Gamble)
b. Patents and trade secrets (e.g. pharmaceutical companies like Pfizer, Merck)
c. Gigantic economies of scale (e.g. Walmart, Amazon.com)
d. Market leadership that competitors will find very difficult to overtake in the next decade (e.g. General Electric, Visa, eBay, Google)
e. High switching costs that lock in customers (e.g. Adobe, Microsoft)
f. Being a monopoly in an industry (e.g. Singapore Press Holdings is a monopoly in the Singapore media industry)

One way to tell if a company has sustainable competitive advantage is to look at its **gross profit margins** (GP) and **net profit margins** (NP). It should have higher GP margins and NP margins as compared to its closest competitors.

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100\%$$

$$\text{Net profit margin} = \frac{\text{Net profit after tax}}{\text{Sales revenue}} \times 100\%$$

Does Yum! Brands pass this criterion? Definitely. Yum! Brands owns some of the strongest brands in the fast food industry that include KFC, Pizza Hut, Taco Bell, Long John Silver's and A&W. The company's sustainable competitive advantage is evidenced from the fact that it has one of the highest GP margins and NP margins in the industry, only second to McDonald's (another great business to invest in).

Company	Gross Profit Margin*	Net Profit Margin*
Yum! Brands	27.61%	10.57%
Wendy's	25%	0.74%
Domino's Pizza	28%	6.38%
Burger King	37.28%	4.28%
McDonald's	39.57%	20.38%

**Figures as of June 2012*

Warning:

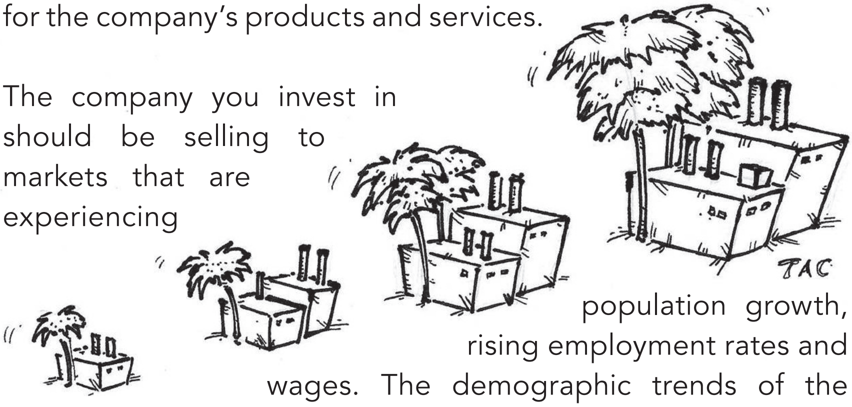
The competitive advantage of technological companies can change rapidly because of new innovations by a competitor. For example, Nokia (NOK) used to have powerful competitive advantage because of its brand, pioneer status in digital mobile and broad range of products.

However, the revolution of the mobile industry by Apple (AAPL) and Samsung has destroyed much of Nokia's competitive advantage. As a result, its sales revenue and net profits have been declining rapidly. Its share price has fallen from a high of $35 to $2.74! Unless Nokia is able to innovate a revolutionary product, its share price will never recover.

On the other hand, non-technological companies like Coca-Cola, Visa, Johnson & Johnson and McDonald's have competitive advantages that last for decades. While technological companies (e.g. Apple, eBay, Google, Facebook) grow the most rapidly, you have to know when to exit the investment once it loses its competitive advantage.

Criterion #3: Future Growth Drivers

Having a good track record and strong sustainable competitive advantage will not automatically translate into higher sales and profits in the future unless there is growing market potential for the company's products and services.



The company you invest in should be selling to markets that are experiencing population growth, rising employment rates and wages. The demographic trends of the market should also be in the company's favor. For example, it may not be a good idea to invest in children-related businesses that sell to Japan and Singapore, where birth rates are declining. However, these would be great businesses if their main customer segments came from India, Vietnam and China.

Would you want to invest in companies like Prada, OSIM and Tiffany & Co. that sell high-end luxury products? It depends. If the main source of their revenue comes from Europe and the US, the business potential will be declining with unemployment rate rising and wages falling in these markets. However, if their main market is in Asia, then you can bet that their revenues and profits will be expected to grow at a high rate.

The Company Should Also Have Solid Growth Plans…

If the company has no plans to create new products or aggressively enter new markets, then future growth in sales will also be limited. You must ensure that the company you want to invest in has some of the following growth drivers:

- Development of new product lines
- Upcoming product innovations
- New application of patents
- Expansion in capacity (e.g. building bigger factories)
- Opening new markets and building more outlets

Where Do I Find This Information?

So where can you find out more about the company's growth plans and market potential? I get all this information from:

a) Company annual reports

Simply search for the company's website and download its latest annual report. If you look under 'CEO's message', you would usually see the company's growth plans and sales forecasts.

b) Analyst reports

Read analyst reports that summarize the company's market potential and growth plans. These reports also include future revenue, profit and cash flow projections done by the analyst. For US companies, I go to analyst research sites like www.morningstar.com.

c) Projected Long-Term Growth Rates

You can also go to research websites like www.reuters.com/finance/stocks to find the long-term growth rate forecasts for listed companies. I usually look for companies that are able to grow at least 10% per annum.

Does Yum! Brands Have Strong Future Growth Potential?

From analyst reports, it is determined that…

Half of Yum! Brands' sales revenue comes from China, a country with tremendous growth potential. China has an emerging middle class of nearly 450 million people (growing at 4% – 5% annually) and a GDP that can triple during the next decade. Yum! is projected to expand to more than 25,000 traditional-format restaurants in China, including 15,000 KFC locations and more than 5,000 Pizza Hut casual dining and home delivery units.

Yum! is also rapidly expanding its restaurants in emerging economies such as India, Indonesia, Malaysia, Vietnam, the Philippines, and several African markets. Yum! is also under-penetrated in several Eurasian markets, including France, Germany and Russia, where it faces only limited competition. There will be sufficient consumer demand among these markets to support another 5,000 new locations over the next decade, putting the Yum! Restaurants International (YRI) segment (all markets outside the US, China, and India) at around 19,500 units by the end of 2021, with another 2,000 units in India. (Source: www.morningstar.com)

Yum! is projected to have a mean long-term growth rate of 13.28%.

Figure 5.11: Yum! Brands Sales and Earnings

	# of Estimates	Mean	High	Low
SALES (in millions)				
Quarter Ending Sep-12	19	3,646.03	3,749.00	3,509.00
Quarter Ending Dec-12	19	4,355.01	4,502.89	4,088.00
Year Ending Dec-12	21	13,886.30	14,155.00	13,392.00
Year Ending Dec-13	20	15,073.40	16,012.40	13,990.00
EARNINGS (per share)				
Quarter Ending Sep-12	21	0.97	1.05	0.91
Quarter Ending Dec-12	21	0.86	0.92	0.80
Year Ending Dec-12	23	3.26	3.35	3.18
Year Ending Dec-13	22	3.74	4.01	3.55
LT Growth Rate (%)	6	13.28	18.00	10.00

Credit: www.reuters.com/finance/stocks

Criterion #4: Conservative Debt

While taking on some debt is a good strategy to raise cash for expansion, taking on too much debt can lead to bankruptcy during a prolonged recession or poor cash flow management.

It is important to ensure that the amount of money borrowed by the company is conservative and can be easily paid back within three to four years. The rule of thumb is that long-term debt should be less than three times of the **current net income** (after tax).

Long-term debt less than
3 × current net income after tax

The company's long-term debt can be found in its balance sheet under 'long term liabilities' or 'non-current liabilities' and as you know, net income can be found in the income statement. Let's look at the Yum! example.

Figure 5.12: Yum! Brands' Balance Sheet

Fiscal year ends in December USD in Million except per share data	2002-12	2003-12	2004-12	2005-12	2006-12	2007-12	2008-12	2009-12	2010-12	2011-12
▾ Liabilities and stockh...										
▾ Liabilities										
▾ Current liabilities										
Short-term debt	146	10	11	211	227	288	25	59	673	320
Accounts payable	1,166	1,213	414	1,238	1,386	639	1,473	499	1,602	1,874
Taxes payable	—	—	—	—	—	—	114	182	61	142
Accrued liabilities	—	—	263	—	—	372	—	342	—	—
Other current liabilit...	208	238	688	156	111	763	110	571	112	114
Total current liabilit...	**1,520**	**1,461**	**1,376**	**1,605**	**1,724**	**2,062**	**1,722**	**1,653**	**2,448**	**2,450**
▾ Non-current liabilitie...										
Long-term debt	2,299	2,056	1,731	1,649	2,045	2,924	3,564	3,207	2,915	2,997
Minority interest	—	—	—	—	—	—	—	89	93	93
Other long-term liabil...	987	983	994	995	1,147	1,117	1,349	1,174	1,284	1,471
Total non-current liab...	**3,286**	**3,039**	**2,725**	**2,644**	**3,192**	**4,041**	**4,913**	**4,470**	**4,292**	**4,561**
Total liabilities	**4,806**	**4,500**	**4,101**	**4,249**	**4,916**	**6,103**	**6,635**	**6,123**	**6,740**	**7,011**

Long term debt $2,977 million in 2012

Credit: www.morningstar.com

Yum! Brands' balance sheet (Figure 5.12) tells us that it has a long-term debt of $2,977 million in 2012. If you look back at the income statement (Figure 5.9), you can see that 'net income' is

$1,528 million. So, since Yum! can easily pay back all its debt with less than three years of its income, it passes the conservative debt criterion.

Note: This debt criterion does not apply to banking and commodities companies that use a high level of debt (known as leverage) to run their businesses.

Criterion #5: Return-of-Equity (ROE) Must Be Consistently above Average (i.e. ROE > 15%)

Return-on-equity (ROE) shows you how much profit a company is generating with the money shareholders have invested in it. ROE is derived from dividing 'net income after tax' by 'shareholders' equity'.

$$\text{Return-on-equity (ROE)} = \frac{\text{Net income after tax}}{\text{Total shareholders' equity}} \times 100\%$$

ROE is a very important figure to look at as a company that shows a high and consistent ROE indicates that:

- The company has sustainable competitive advantage
- Your investment in the form of shareholders' equity will grow at a high annual rate of compounding that will lead to a high share price in the future

Generally, a company that has an ROE of 12% is considered a fair investment. Companies that are able to generate an ROE of more than 15% consistently are very rare and considered great investments.

Because ROE is so commonly used in evaluating companies, you usually do not have to calculate it yourself. ROE figures are usually presented in a company's annual report under 'financial performance summary' or under 'financial ratios'. You can easily find a company's history of ROE from www.morningstar.com under 'key ratios'. You can see from Figure 5.13, that Yum! Brands again easily passes this criterion by having an ROE of 77.61% in 2012.

Figure 5.13: Yum! Brands Key Ratios

Profitability	2002-12	2003-12	2004-12	2005-12	2006-12	2007-12	2008-12	2009-12	2010-12	2011-12
Tax Rate %	32.05	30.25	27.88	25.73	25.63	23.68	24.69	22.42	26.10	19.53
Net Margin %	7.52	7.36	8.21	8.15	8.62	8.73	8.55	9.88	10.21	10.45
Asset Turnover (Average)	1.59	1.52	1.59	1.64	1.59	1.53	1.64	1.58	1.47	1.47
Return on Assets %	11.91	11.20	13.08	13.38	13.68	13.37	14.00	15.66	14.98	15.38
Financial Leverage (Average)	9.09	5.02	3.57	3.93	4.42	6.36	—	6.97	5.28	4.85
Return on Equity %	167.05	72.00	54.51	50.07	57.10	70.57	187.00	233.59	89.04	77.61
Return on Invested Capital %	21.63	19.82	22.69	22.93	23.48	22.56	24.62	27.56	24.50	25.60

Return-on-equity 77.61% in 2012

Credit: www.morningtar.com

Criterion #6: Management is Holding or Buying the Company Stock

The next factor to look at is whether the company's own directors are holding, buying or selling their own shares. If you find that key senior directors like the CEO, CFO or chairman are collectively selling a large proportion of their own stock, then it may not be as good an investment as it seems. Think about it. If the company's own directors don't have faith in their own stock, how can you?

At the same time, if you find that the senior management is collectively buying a large amount of company stock, it means that they have confidence that they are getting a good deal at the current price. Who else would know the company's value better than the people who are running it?

Whenever more than three directors in a company are collectively buying its shares, it is usually a good indication that the share price will soon rise. For example, on 22 May 2012, eight directors from CapitaLand bought shares in the real estate company at $2.51. Two weeks later, the share price reversed to a new uptrend and rocketed +56% to $3.90 within the next eight months.

Figure 5.14: CapitaLand Stock Transactions by CapitaLand Directors

Announce Date	Date of Effective Change	Buyer / Seller Name	Type a	S / W / U b	Bought / (Sold) ('000)	Price ($)	Closing Price ($) d	After Trad
								No. of Shares ('000) c
24 May 2012	22 May 2012	Peter Seah Lim Huat	DIR	S	27	-	2.510	329
24 May 2012	22 May 2012	James Koh Cher Siang	DIR	S	21	-	2.510	282
24 May 2012	22 May 2012	Arfat Pannir Selvam	DIR	S	23	-	2.510	231
24 May 2012	22 May 2012	Kenneth Stuart Courtis	DIR	S	22	-	2.510	160
24 May 2012	22 May 2012	Simon Claude Israel	DIR	S	20	-	2.510	70
24 May 2012	22 May 2012	Ng Kee Choe	DIR	S	14	-	2.510	24
24 May 2012	22 May 2012	John Powell Morschel	DIR	S	18	-	2.510	24
24 May 2012	22 May 2012	Goh Yiu Kiang Euleen	DIR	S	4	-	2.510	9

Credit: www.shareinvestor.com

Chart 5.15: CapitaLand Reverses to Uptrend

Credit: www.chartnexus.com

As you can see, knowing what the insiders of a company are doing is very important. You can easily find out recent insider trades by going to www.moneycentral.com (US stocks) and www.shareinvestor.com (Singapore stocks). Under the section on 'insider trading', you can find all the information related to the stock purchases, sales and current holding of the company's employees. You can also go to the website of the respective stock exchange where insider purchases/sales are recorded.

Let's take a look at the insider trading activity of Yum! Brands.

Figure 5.16: Insider Trading Activity of Yum! Brands

Credit: www.moneycentral.com

From Figure 5.16, you can see that Yum! does not fare very well under this criterion. There are no reported employees buying the shares but several selling their shares. However, there is no cause for panic as none of the employees selling are senior directors and the proportion of shares being sold is relatively small (maybe they wanted to buy a new house for Christmas).

If the stock you are evaluating passes the first six criteria, it means that you have found a great business that is financially strong and will continue to grow in value. Just like finding a beautiful jacket in a department store that fits you perfectly, you would want to make sure you are getting a great deal on the price before you make the purchase. The next two criteria will tell you if it is the right time to buy.

Join me in the next chapter and I will show you the last two criteria. You are going to learn how to calculate the intrinsic value of the company's stock and to time your entry by studying the price trend.

SIX
CHAPTER

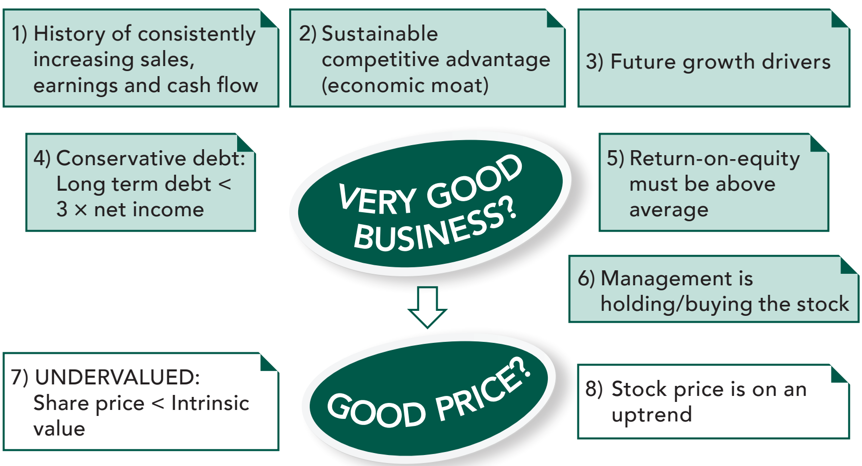
How to Pick Stocks of Winning Companies II

How to Pick Stocks of Winning Companies II

CHAPTER SIX

In the last chapter, you learned the first six criteria in identifying great businesses to invest in. We will now look at the last two criteria to ensure that you make your investment at the right price and at the right time.

Overview of the Eight Criteria for Winning Stocks



Criterion #7: Stock Is Undervalued: Share Price < Intrinsic Value

No matter how great a business is, you never want to overpay for it. It is only a great investment if you can purchase this great company at a price that is below its true value (known as 'intrinsic value').

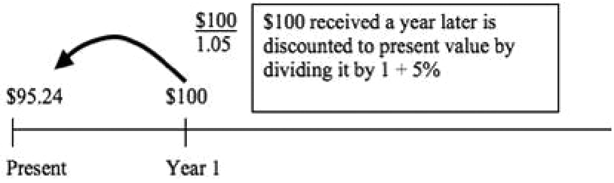
To explain how we value companies, let me explain using an analogy.

Imagine that there is a machine that prints money. What is the most you would pay for a machine that would print $100 for you today? The answer is $100! If you paid $100 for a machine and it pays you back $100, you would breakeven. So, $100 is the most you would pay.

Now, what is the most you would pay for a machine that would print $100 one year from today? Would you pay $100? Of course not. You would definitely pay <u>less</u> than $100, as you would have to wait a year to get your $100 back. So, what is the maximum you would pay today? The answer depends on the **opportunity cost** of your money.

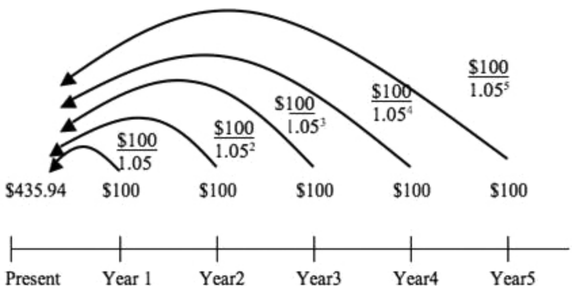
If you could put your money into a bank and get an interest of 5% per year, then your opportunity cost would be 5%. This is also known as your **discount rate**.

If the discount rate is 5%, then you would pay a maximum of $95.24 ($100 ÷ (1+ 0.05)) for the machine today. Why? Well, if you were to put that $95.24 in the bank earning 5%, you could get $100 a year later. So, $95.24 is the present value you would place on $100 to be received a year later. In other words, <u>money received in the future is worth less today</u>. To find out the present value of $100 received in one year, we divide it by 1 + 0.05 (discount rate) to get $95.24. This is known as discounting future value to present value.



$100 received one year later is worth $95.24 today.

Now, how much would you pay for a machine that would print out $100 in the first year, $100 in the second year, $100 in the third year and so on till the fifth year? To find the answer, you would have to discount each future payment to its present value and sum them all up.



$100 received in Year 1 is worth $100/1.05 = $95.24 today
$100 received in Year 2 is worth $100/1.05^2 = $90.70 today
$100 received in Year 3 is worth $100/1.05^3 = $86.38 today
$100 received in Year 4 is worth $100/1.05^4 = $82.27 today
$100 received in Year 5 is worth $100/1.05^5 = $78.35 today

So, the present value of the entire five payments is $435.94 ($95.24 + $90.70 + $86.38 + $82.27 + $78.35). Thus, the machine is worth a maximum of $435.94 today.

What has this machine analogy got to do with valuing companies? Well, a company is like a "money-making machine" that prints profits and cash every year. When you buy the company's shares, you are buying part of a machine that would generate cash every year, year after year. Therefore…

The intrinsic value of a stock is equal to the present value of all its future cash flow from operations.

In theory, the intrinsic value of a company is calculated by adding up all its future operating cash flow to perpetuity and then discounting it to the present value. However in reality, companies do not last forever. To be very conservative, assume that the company will only last for ten more years.

So, we will calculate the intrinsic value of a stock by adding up all the projected cash flow from operations over the next ten years and discounting it to the present value.

We need to also take into account the total amount of cash and equivalents the company has and subtract its total debt owed. We then take the company's net cash (i.e. total cash - total debt) and divide it by the number of shares outstanding. As a shareholder, you are entitled to this 'net cash' per share as well. You have to therefore factor this figure into the intrinsic value per share.

Calculating the Intrinsic Value of One Share of Yum! Brands

Let's once again take the example of Yum! Brands and calculate the intrinsic value of each share today (2012). Here are the steps.

Step 1: Project Yum!'s Cash Flow for the Next 10 Years

How much cash will Yum! pay out over the next 10 years? We have to take Yum!'s most recent 'cash from operations' (TTM - last 12 months) and project it with the estimated 'long-term growth rate'.

From its 'statement of cash flows', you can see that Yum!'s 'cash from operations' was $2,171 million for TTM (last 12 months).

Figure 6.1: Yum! Brands Statement of Cash Flows

Fiscal year ends in December USD in Million except per share data	2002-12	2003-12	2004-12	2005-12	2006-12	2007-12	2008-12	2009-12	2010-12	2011-12	TTM
▾ Cash Flows From Operat...											
Net income	583	617	740	762	824	909	964	1,083	1,178	1,335	1,540
Depreciation & amortiz...	370	401	448	469	479	542	556	580	589	628	638
Investment/asset impai...	—	—	—	—	—	—	43	103	47	135	52
Investments losses (ga...	—	—	—	—	—	—	41	—	—	—	—
Deferred income taxes	21	(23)	142	(101)	(30)	(95)	1	72	(110)	(137)	(99)
Stock based compensati...	—	—	—	—	—	—	59	56	47	59	56
Accounts receivable	—	—	—	—	—	—	(6)	—	—	(39)	(32)
Inventory	11	(1)	(7)	(4)	(3)	(31)	(8)	27	(68)	(75)	(81)
Prepaid expenses	19	—	(5)	78	(33)	(6)	4	(7)	61	(25)	(11)
Accounts payable	—	—	—	—	—	—	18	—	—	144	97
Income taxes payable	—	—	—	—	—	—	39	(95)	104	109	107
Other working capital	54	66	(190)	47	(12)	249	66	(59)	49	101	137
Other non-cash items	30	(7)	3	21	77	(1)	(256)	(356)	71	(65)	(233)
Net cash provided by o...	**1,088**	**1,053**	**1,131**	**1,272**	**1,302**	**1,567**	**1,521**	**1,404**	**1,968**	**2,170**	**2,171**

Credit: www.morningstar.com

From Figure 6.2, you can see that Yum!'s long-term growth rate is 13.28%.

Figure 6.2: Yum! Brands Sales and Earnings

	# of Estimates	Mean	High	Low
SALES (in millions)				
Quarter Ending Sep-12	19	3,646.03	3,749.00	3,509.00
Quarter Ending Dec-12	19	4,355.01	4,502.89	4,088.00
Year Ending Dec-12	21	13,886.30	14,155.00	13,392.00
Year Ending Dec-13	20	15,073.40	16,012.40	13,990.00
EARNINGS (per share)				
Quarter Ending Sep-12	21	0.97	1.05	0.91
Quarter Ending Dec-12	21	0.86	0.92	0.80
Year Ending Dec-12	23	3.26	3.35	3.18
Year Ending Dec-13	22	3.74	4.01	3.55
LT Growth Rate (%)	6	13.28	18.00	10.00

Credit: www.reuters.com/finance/stocks

Since the cash flow from operations is $2,171m in 2012, we can project that it will be $2,459m in 2013, $2,785m in 2014, $3,155m in 2015 and so on (just increase it by 13.28% each year). This can be seen in Figure 6.2 under 'cash flow (projected)'.

Step 2: Calculate the Right Discount Factor (DF)

Now, remember that money received in the future is worth less today. So, we have to discount all future cash flow by a discount factor to arrive at the present value of the future cash.

This discount factor is the opportunity cost of your money. So, the riskier (volatile) the stock, the higher the discount factor you should use. You need to demand a higher rate of return to compensate for the additional risk you are taking.

So, how do you know how risky (volatile) a stock is? Oneway is to check the stock's **beta** value. A beta that is more than 1 means the stock is more volatile that the overall market index. A beta that is less than 1 means the stock is less volatile. You can find out a stock's beta by going to www.reuters.com/finance/stocks. As you can see below, YUM is a relatively safe stock with a beta of 0.90. You can also see that YUM has 455.85 million shares outstanding (you will need this later).

Figure 6.3: Yum! Brands Sales and Earnings

OVERALL	
Beta:	**0.90**
Market Cap (Mil.):	**$30,131.69**
Shares Outstanding (Mil.):	**455.85**
Dividend:	**0.28**
Yield (%):	**1.72**

Credit: www.reuters.com/finance/stocks

Once you know the stock's beta value, you can use an appropriate discount rate based on the table below.

Table 6.4: Discount Rate Based on Beta Value

Beta	**Discount Rate**
Less than 0.80	5%
1	6%
1.1	6.8%
1.2	7%
1.3	7.9%
1.4	8%
1.5	8.9%
More than 1.6	9%

Since YUM's beta is 0.90, we will take a discount rate of 5%. The **discount factors** (DF) are derived by dividing 1 by 1.05n, where 'n' is the number of years to be discounted. Thus the discount factors you see in Figure 6.5 are 0.95 (1÷ 1.05), 0.91 (1÷1.052), 0.86 (1÷1.053) and so on.

Step 3: Discount All Future Cash Flows to Present Value (DV) and Sum Them Up

The '**discounted value**' (DV) of all the future cash flows is derived by multiplying the projected cash flow with the discount factor (DV = Cash flow (projected) × Discount factor). From Figure 6.5, you can see that the discounted values (DV) of all the future cash flows are worth $2,342m, $2,526m, $2,726m and so on.

Figure 6.5: Calculating Intrinsic Value for YUM

In this case, the intrinsic value of the whole company would be the sum of all the future 'discounted cash flow' for the next 10 years
= Add up all the discounted values
= $2,342.2m + $2,526.9m + $2,726.2m +……..+ $4,637.7m
= $33,746.8 million (PV of 10-year cash flows)

Step 4: Find the Value of Each Share

Now that we know how much the whole company is worth, how much is one share worth?

To get the intrinsic value of <u>one share</u> based on its future cash flow, take $33,746.8 million and divide it by the total number of shares outstanding (i.e. 455.9 million shares).

$$\text{So, the intrinsic value of one share} = \frac{\$33{,}746.8 \text{ million}}{455.9 \text{ million}} = \$74.03$$

To be even more accurate, we then add the 'net cash per share'. This is

$$= \frac{\text{Cash and equivalents - Total debt}}{\text{Total shares outstanding}}$$

$$= \frac{\$1{,}198 \text{ million} - \$3{,}317 \text{ million}}{455.9 \text{ million}} = -\$4.65 \text{ per share}$$

Note: 'Cash and equivalents', 'short-term debt' and 'long-term debt' can all be found in the balance sheet of the annual report

So, the intrinsic value of one share (less debt, plus cash)
= $74.03 - $4.65
= <u>$69.38</u>

While I am writing this book (August 2012), YUM shares are trading at $66.10, which means that they are priced 5% below their intrinsic value of $69.38. So, this great stock is indeed undervalued.

Calculating a stock's intrinsic value may seem complicated and solvable only by a math whiz. However, I coach my Wealth Academy™ students to do all this in less than 5 minutes using the 'Intrinsic Value Calculator' that has all the formulas pre-programmed.

Criterion #8: Stock Price Is on Uptrend

Finally, before you pull the trigger, always ensure that the stock you are buying is on an uptrend! Remember from Chapter 3 that you should only buy a stock (or an index ETF) when it is on an uptrend. Recall that an uptrend is characterized by a stock price making higher highs and higher lows.

When a stock is on an uptrend, it means that people are getting more and more optimistic about the stock and the probability is that the stock is going to move higher in the short term. The best time to buy would be when the stock makes a dip on its uptrend.

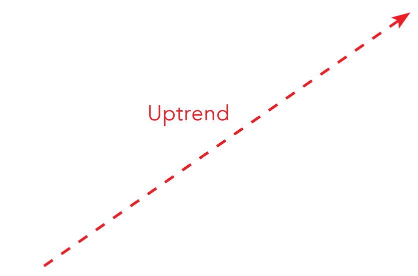
A good indication of an uptrend is when the stock price's 50-day moving average (50 DMA) is above the 150-day moving average (150 DMA) and both moving averages are sloping upward.

Is YUM on an Uptrend Yet?

You can see from Chart 6.6 that YUM's stock price has just gone through a correction from May to August 2012. Although the 50 DMA (blue) has crossed below the 150 DMA (green), the 150 DMA is still sloping upward. Thus, YUM is not on a confirmed downtrend.

However, to be safe, I would wait for the 50 DMA to cross back above the 150 DMA before confirming the uptrend and making a buying entry.

Chart 6.6: YUM Stock Chart 2012



Credit: www.thinkorswim.com, ProphetCharts®

Warning

No matter how great a company is or how cheap the stock price may be, it is risky to buy when the stock price is still on a downtrend (price is making lower highs and lower lows). This is indicated by the 50 DMA falling below the 150 DMA and both MAs sloping downward.

In the short term, pessimism in the market is likely to push the price even lower, making your cheap stock even cheaper. Never catch a falling knife as you do not know how low a stock can go. If you take a look at Chart 6.4, you can see Halliburton (HAL) on a downtrend. Although HAL is a great oilfield services business with an intrinsic value of $58, pessimism about oil prices keeps pushing the price to ridiculous new lows.

I always find that the smart thing to do is to be patient and wait for the downtrend to reverse to an uptrend. That way, I get to buy in at an even better price and at a time when the price is ready to make an upward move. When HAL eventually reverses back to an uptrend, it would make a great buy!

Chart 6.7: Halliburton (HAL) Stock Chart

Finding Great Investment Opportunities

Credit: www.thinkorswim.com, ProphetCharts®

Now that you know the ingredients that make a great stock investment, how do you go about looking for opportunities? There are over 8,000 stocks listed on the US stock exchange and hundreds more listed on other exchanges around the world. Where do you start looking? Here are the sources where I find my winning stocks:

1) Read the News For Good and Bad News

As a successful investor, you have to develop the curiosity of reading the business and financial news daily. I get the news from websites like www.google.com/finance, www.cnbc.com and www.briefing.com. You can also find investment opportunities from the business section of your local newspapers and from finance newspapers like 'The Edge' and 'The Wall Street Journal'.

I look for both bad news and good news that can present great investment opportunities. Here are some examples of bad news that caused the share prices of various companies to fall significantly, giving me the opportunity to short sell the stock and to subsequently buy at discounted prices (if the underlying company was still fundamentally good):

- 20 April 2010, British Petroleum's (BP) Deep Horizon Oil Spill
- 10 May 2012, JP Morgan Loses Billions in Rogue Trading Scandal
- 6 August 2012, Standard Chartered Bank Investigated for Dealing with Iran
- 22 August 2012, Hewlett Packard Posts $8.9 Billion Quarterly Loss
- 25 August 2012, Samsung Loses Its Patent Lawsuit with Apple

At the same time, I also look out for good news such as companies winning contracts, having their patents approved or reporting better-than-expected results. I will then do an analysis on the company and see if the stock price is breaking out to a new uptrend.

2) Look at Companies That You Patronize

One of the simplest but most effective techniques is to invest in the companies whose products or services you use regularly. Warren Buffett's most successful investments were in Coca-Cola, American Express, The Washington Post, Nike, Procter & Gamble and Johnson & Johnson. He used their products regularly and figured that many people, like him, are providing a steady stream of revenue and profits to these companies. This makes them great investments. So, while Buffett enjoyed drinking his six cans of Coke a day, the Coca-Cola company has made him billions of dollars in profits.

If you are a typical Singaporean, the following are the products or services you may be using regularly. Check out the companies' stock price performance and you will be surprised to see how successful they have been.

Activity	Product(s) Used	Company	Stock Exchange
Brush your teeth	Colgate	Colgate-Palmolive (CL)	Listed on NYSE
Wash up	Toiletries: Shampoo, powder, facial wash, toilet paper, diapers	Procter & Gamble (PG), Johnson & Johnson (JNJ)	Listed on NYSE
Eat breakfast	Groceries from 7-Eleven and Cold Storage	Dairy Farm	Listed on SGX
Travel	Public transport	SMRT, ComfortDelGro	Listed on SGX
	Vehicle petrol	Exxon Mobil (XOM)	Listed on NYSE
	Vehicle inspection	VICOM	Listed on SGX
Lunch at a restaurant	McDonald's, A&W, Pizza Hut	McDonald's (MCD), Yum! Brands (YUM)	Listed on NYSE

Go ahead and think of even more products you use and the companies that make a profit from you every day!

3) Get Ideas from Analyst Reports

You can also get great ideas from reading analyst reports. Analysts from stock broking companies will report on stocks they recommend to buy, sell or hold. Although I would never blindly follow a recommendation (they could be wrong), I would look at their buy recommendations to short-list interesting stocks that I can start to analyze by myself.

Some of my great stock investments in companies like Goodpack, OSIM International and Sakari Resources came from analyst reports. Do instruct your stockbroker to send you these free reports regularly.

4) Get Ideas from Mentors and Investment Buddies

Stock investing can be a lonely game and it may be difficult to find the best investment ideas by yourself. It is always a great idea to join an investment club or to find a group of friends who are savvy investors so that you can exchange ideas regularly.

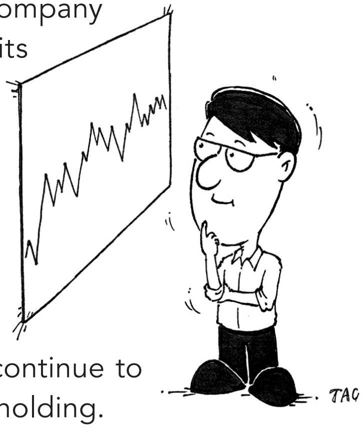
Students of my *Wealth Academy™* program meet monthly at our private Wealth Academy Investors Inner Circle (WAIIC) meetings where members take turns sharing their best investment ideas for that month. As one of their mentors, I also share opportunities I have discovered and give them access to see my stock picks live from my private website.

Figure 6.8: Adam Khoo's Stock Picks (Jan 2013)

Credit: www.wealthacademyinvestor.com

Monitoring Your Portfolio: Buy and Watch!

Once you have invested in a portfolio of stocks, you need to monitor their progress regularly to ensure that the stock price stays on an uptrend and that the company continues to report sales and profits that are in line with expectations.



This is why you should not invest in more than 8 to10 stocks at any one time (unless you are a professional investor). If you have too many stocks to look at, you will not have the time to monitor their progress and may continue to hold a stock that is no longer worth holding.

Do you have to spend a lot of time to watch your nest egg? Not really. If you invest in large, defensive companies with predictable earnings, taking a look once a month is fine. In the next chapter, you are going to learn that defensive companies sell products and services that are not affected by the state of the economy.

On the other hand, if you invest in smaller, riskier companies or companies that are cyclical in nature, then you should take a look at the stock price chart at least once a week. Cyclical companies are more affected by economic conditions.

Monitor Share Prices Weekly

Look at the price charts at least once a week. Personally, I have the habit of checking the market twice a day, an hour after the market opens (10a.m.) and an hour before the market closes (4p.m.).

Do not be overly concerned about the daily and weekly fluctuations in the share price. It is normal. Amateurs tend to get freaked out when their stock drops by a few points and get excited again as it bounces back up. The more you look, the more emotional you get and the worse decisions you make.

You only need to pay attention to the 'trend' of the stock price by looking at your moving averages and support/ resistance lines. You only have to take action if there is a change in trend signal.

Monitor Quarterly Financial Reports

Every three months, companies report their quarterly financial results. You can find out the date of a US stock's next earnings release at www.google.com/finance. You can subsequently download and read the reports from the company's website.

Figure 6.9: Nike Financial Report

Credit: www.google.com/finance

For Asian stocks, go to the website of the stock exchange where all the results are posted. For example, you can go to www.sgx.com for Singapore stocks and www.klse.com.my for Malaysian stocks. For Hong Kong stocks, a great website to go to is www.aastocks.com.

Check your company's quarterly sales revenue, net profit, cash flow from operations and profit margins to ensure that they are on track to meet their growth targets. If you notice deterioration in the company's fundamentals and it does not seem temporary, consider exiting the investment.

Knowing When to Sell

To be a successful investor, you have to learn when to sell your stocks to take profits or to cut your losses. The main reason why investors end up losing money or not being able to maximize their profits is because of failing to sell at the right time. In fact, I have found that knowing when to sell is more important than knowing what to buy and when to buy. Two investors buying the same stock at the same time can get very different results depending on when they hit the sell button.

Imagine if you had bought Research In Motion (RIMM) (maker of BlackBerry) at $20. If you did not know when to sell RIMM when it lost its competitive advantage and went on a downtrend, all the profits you may have made from 2006 to 2008 would have been evaporated. Worse still, you could have ended up losing everything you put in. Selling at about $100 would have made a difference between a 700% profit and a -65% loss (if you had sold at $7).

Chart 6.10: Research In Motion (RIMM) 2006 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

It is very easy to make a purchase. However, it is psychologically very difficult to sell a stock. As you can see below, untrained investors will always find excuses for not selling a stock under all three scenarios. As a result, they never hit the sell button until they lose it all.

Scenario 1: When the Price Falls below Your Purchase Price
They say, "If I sell now, I will realize a loss. I will sell when it gets up back to even."

Scenario 2: The Price Keeps Going Up
They say, "Why sell now when it keeps going up? I will sell when it stops going up."

Scenario 3: The Price Starts Falling after Rising to a New High
They say, "I should have sold it when it was higher. I'll wait for it to get back to its high."

In every possible scenario, the untrained investor will always find an excuse not to sell yet. Fear of taking a loss will cause him to keep holding even when the stock goes down and the greed for even more profits will cause him to keep holding when the stock goes up.

Training Yourself to Sell

To be a profitable investor, you have to train yourself to have the discipline to sell. The moment I mastered this discipline, I started making more money than ever before.

The secret is to know when you are going to sell even before you make the decision to buy. Most people only think about selling after they have bought the stock. As a result, their emotions cloud their judgment and they start to get confused when the stock price moves in the opposite direction.

Selling Rules

There are two main reasons you should sell a stock: Fundamental reasons and technical reasons.

1) Fundamental Reasons — Company Is No Longer Profitable

If reports from the company show that it is losing its competitive advantage or its management is not acting in the best interests of shareholders, then you need to sell immediately. If the company is no longer a good business, there is no point hanging on. Here are a few reasons to sell:

a) Management is accused of mismanagement
b) Two or more directors sell a large proportion of their stock
c) Profit margins decline for more than four quarters while competitor companies continue to show consistent margins
d) Accounts receivable start to increase much faster than the increase in sales revenue

I may also sell the stock of a good company if I find an even better investment. In other words, I find another company that has much higher growth rates and is selling at a much better discount.

2) Technical Reasons — Emotions Have Turned Pessimistic

I will also sell a stock if the price reverses to a downtrend as indicated by the moving averages (i.e. 50 DMA crosses below the 150 DMA, and both start sloping downward).

Even if the company is still great and the price is undervalued, I would still sell on a downtrend. I would rather wait for the price to go as low as it can and get the chance to buy it back when it starts a new uptrend again.

Many other investors would rather hold on to the declining stock, believing that it will make a comeback, since it is still a fundamentally good stock. While that is true, you never know how long it will take to come back. Instead of having your money stuck, isn't it better to sell, keep the cash and get in at a better price later. Besides selling a stock when it reverses to a downtrend, I also exit a position when there is a need to cut losses and protect profits.

3) Cut Losses with Stop-Loss Orders

Would you go mountain climbing without a safety rope? Would you drive a Formula One car at 250km/h without a helmet and a seat belt? I highly doubt it. In undertaking any kind of challenge, we must always accept the fact that things can go wrong — sometimes beyond our control. But even if things do go horribly wrong, they should never do so much damage that we cannot continue with our challenge.

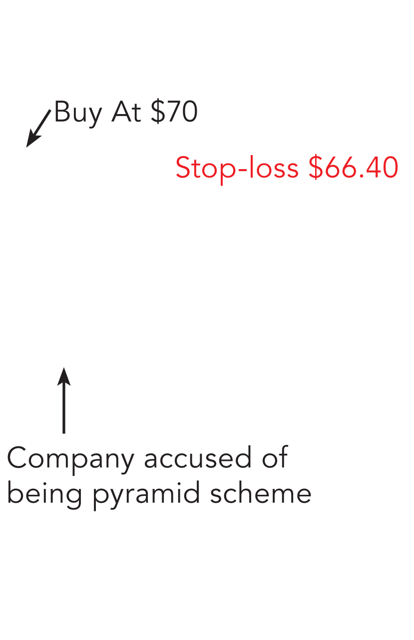
No matter how well you analyze the fundamentals of a company or the technical signals of a stock, the price will not always move in your favor. For example, you can invest in one of the strongest network marketing companies like Herbalife (HLF) at a time when it is on a confirmed uptrend. However, if there is sudden news that the company is being accused of being a pyramid scheme (which you could never have known about), the stock price could go into a drastic decline. If you do not sell fast and minimize your losses, one bad investment could do irreparable damage to your capital.

This is why I always place a **stop-loss order** approximately 6% – 8% below my purchase price. For example, if I bought HLF stocks at $70, my stop-loss order would be placed at $64.40. This is an order placed with your online broker to ensure that if the stock falls to the predetermined stop price (e.g. $64.40), the broker will automatically sell your shares at the prevailing market price.

The reason I place stop-loss orders at 6% – 8% below my purchase price is because I have found that most of the time, when you buy a stock that is on an uptrend, it will unlikely fall more than 6% – 8% while resuming its uptrend. If the price falls more than 6% – 8%, there is a high probability that the uptrend has failed. In such an instance, I would rather minimize my losses and use my capital on a more lucrative investment.

Many people do not like to place stop-losses because they feel that it is tantamount to "admitting defeat" before they even start. The egoistical need to be right causes them to avoid placing a "fail-safe switch". I, for one, see stop-losses as insurance policies against the unexpected. You can see from the example (Chart 6.11) that a person who had placed a stop-loss of $64.40 on a purchase of HLF at $70 would have been saved from a much bigger loss if he had not sold fast enough.

Chart 6.11: Herbalife (HLF) 2012 – 2013



Credit: www.thinkorswim.com, ProphetCharts®

By minimizing your losses when investments go bad, you will find that the profits you make from the good investments will easily cover these small losses and result in an overall profitable outcome for your portfolio. In fact, even if you are right only 50% of the time, you will still make a high return if your gains outweigh your losses. Placing stop-losses is the only way to ensure this.

4) Protect Profits by Selling 5% below the High

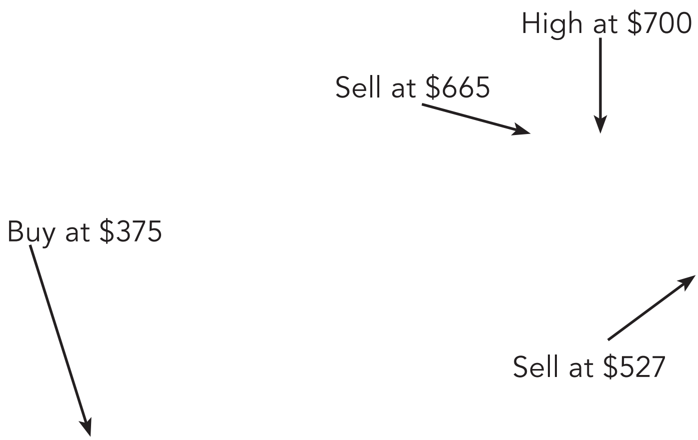
Another selling strategy I use is meant to protect unrealized profits I have made in a winning investment. Have you experienced a situation where you were sitting on a winning investment and then the price started to decline and your potential profits were all wiped out?

To prevent this from happening, I have a rule of selling a stock whenever its price falls 5% below a recent high. The reason I do this is because if I waited to sell only when the price has confirmed a downtrend, a lot of potential profits would already have been eliminated.

Take a look at an example of Apple on Chart 6.12. Smart investors would have bought Apple at $375 when the 50DMA crossed above the 150 DMA. Apple then proceeded to climb to a high of $700 before starting its decline. By following the rule of selling 5% below the high, I exited Apple at $665, locking in a $290 profit (+77.3% gain).

If I had waited to sell only when the 50DMA crossed below the 150 DMA, I would have exited at $527, making a smaller profit of $152 (+40.5% gain).

Chart 6.12: Apple (AAPL) 2011 – 2013



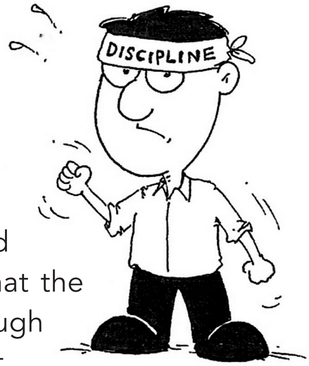
Credit: www.thinkorswim.com, ProphetCharts®

Note that by selling a stock when it falls 5% from its recent high, there is a chance that the price may bounce back up since the downtrend has not been confirmed. In these situations, I will buy the stock back (even at a slightly higher price) and ride the rest of the uptrend to the next high point. If you want to modify this rule to sell when the price falls 6%, 7% or 8% below the recent high, you are free to do so. You may give up slightly more of your profits if the price declines but it will prevent you from selling too early when the price makes a bigger dip on its continued uptrend.

Have the Discipline to Sell Great Companies… and Buy Them Back at a Better Time

Having the discipline to sell at the right time has saved me hundreds of thousands of dollars and allowed me to make consistent profits over time. Here is an example of a time when I sold the stock of a company that was still great and then buying it back at a much lower price.

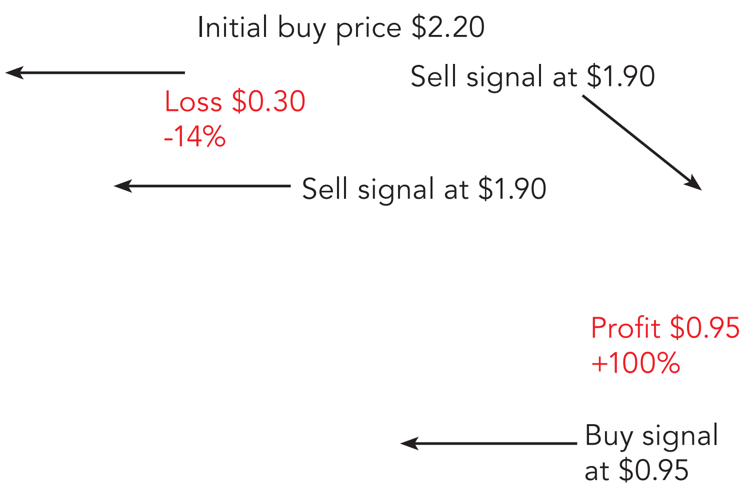
In late 2007, I bought shares of Goodpack, a Singapore listed company in the logistics business at $2.20. It is a great company with a solid competitive advantage and great future growth prospects. Unfortunately, two months later, the US financial crisis erupted and stock markets around the world came crashing down.



Within 7 months, the price came down to $1.90. The 50 DMA had just crossed below the 150 DMA and it was clear that the stock was on a downtrend. Even though I still believed in the business and felt that it was worth much more, there was no point fighting the "landslide" caused by financial crisis. Although I did not sell when the stock fell 5% from its high, I exited when the downtrend was confirmed.

As an investor, I have learned that taking a loss is part of the game. If the company is still good, I will have the opportunity to make it back at a later time. Over the next few months, the stock continued to fall to a low of $0.60 before reversing back to an uptrend.

Chart 6.13: Goodpack Stock Chart 2008 – 2011



Credit: www.chartnexus.com

In August 2009, the uptrend signal was confirmed and I bought back the shares at $0.95. I made a subsequent profit of 100% when I sold the shares at $1.90. If I had stubbornly held on to the shares when I bought them back in 2007, I would have had my money stuck in there for 18 months and would have still made a loss.

Psychology of Successful Investors

Congratulations! You now have all the knowledge and strategies of how to invest successfully. However, what if I told you that know-how is not enough? To be successful, you must also have the right mindset of a successful investor.

People who attend my investing courses and learn all my strategies can still produce different results, simply because of the difference in their psychology. Learning all the right techniques is useless, unless you adopt the psychology that all successful investors possess.

Here are five rules of investing psychology that you have to understand if you want to make money in the markets.

Rule 1: You Cannot Predict the Market

Untrained investors fall for the idea that there is a way to predict the direction of the economy or the stock market. As a result, they seek out investment gurus, economists, analysts or trading software that they believe can tell them where prices will go tomorrow. They make investment decisions based on these predictions.

Investment professionals know that nobody and no software system can predict the stock market direction. It is impossible to predict the market! Why? Remember that in the short term, stock prices are driven by demand and supply, which is in turn driven by the emotions of millions of buyers and sellers around the world. If you can't even predict the mood swings of your spouse tomorrow, how can you possibly predict the emotions of millions of strangers? Market sentiment can change suddenly when news is released. If you cannot predict tomorrow's newspaper stories, you cannot predict the market!

The funny thing is that when you read or watch the news on channels like CNBC, "experts" give all kinds of predictions every day. For every expert that says that the stock market will go up, another expert will say that it will go down. In fact, on 22 September 2011, legendary trader George Soros said that the US was already in a double-dip recession. Within a few days (30 September 2011), Warren Buffet said that a US recession was "very, very unlikely". Even the "investing gods" cannot agree where the economy and market is going!

Credit: www.cnbc.com

Credit: www.cnbc.com

Here is another example of how different predictions can be. On 6 October 2009, the Dow Jones index was trading at 9,500 points. CNBC ran a news report that said that experts expect the Dow to hit 10,000 points. A day earlier, it was reported that a portfolio manager expects the Dow to fall to 6,300 points. So, who are you going to believe?

Credit: www.cnbc.com

Credit: www.cnbc.com

The lesson is this: Stop trying to predict where the market is going. It is futile. Also, stop listening to the predictions of other people, no matter how smart they may appear to be.

Being a successful investor has nothing to do with making predictions. Instead, we need to analyze where the valuation and trend of the market is today. That is something that we can determine. If the index or stock is undervalued and on an uptrend, we know we can go long. If the stock is overvalued and on a downtrend, we need to sell or go short. It is that simple!

Rule 2: Become an Expert, Never Rely on Experts

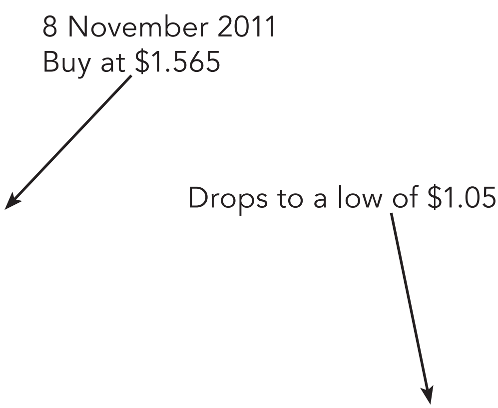
It is always in our human nature to want to listen to the expert advice of others, especially the so-called professional analysts and money managers. Many people think it is too much work to do their own research and to monitor stocks themselves. So, they take the easy way out by blindly following the advice of investment experts and blame them when things go wrong.

If you want to be successful, you have to work hard to do your own research and know exactly what you are investing in. Only invest in what you understand. If you do not understand how a company makes its money, don't buy its stock!

Here is an example of how you could have lost money if you had blindly followed the buy recommendations of an analyst report. On 8 November 2011, there were many buy recommendations by analysts from leading stock broking firms. In fact, in one report, the stock was assigned a target price of $2.05. That is a 24% upside to its price of $1.565 at that time.

Contrary to the report's optimistic recommendations, if you had bought Noble Group's stock at $1.565 and failed to notice that it was on a downtrend (i.e. 50 DMA below 150 DMA), you would have seen the stock price drop to a low of $1.05!

Chart 6.14: Noble Group (N21) Downtrend (Jun 2011 – Sep 2012)



Credit: www.chartnexus.com

Rule 3: Buy and Sell on Predetermined Rules

The third rule is to only make buy and sell decisions based on the predetermined fundamental and technical rules you have learned. Stick to the rules consistently and your gains will far outweigh your losses. Never make your decisions based on rumors, opinions and emotions. They are never reliable.

Rule 4: Admit Your Mistakes and Take Responsibility

The only way to protect your capital when you are wrong is to admit your mistakes early. The only way you can become smarter and better the next time is to take responsibility and learn from your mistakes.

No matter how smart or hardworking you are, you are bound to make mistakes. I have made countless mistakes in my business and investing career. Never stubbornly hold on to an investment believing that you are right, when the company reports poor results and the stock is on a downtrend. Hoping that the company and its stock will miraculously turn around is a recipe for disaster. Be quick to cut your losses, learn from your experience and find the next better investment.

If you give yourself excuses and blame your luck, the market, the analyst or your broker, you will be doomed to make the same mistakes over and over again.

Rule 5: There Is No Sure-Win Investment

Finally, successful investors know that there is no such thing as a sure-win investment strategy. Anything can happen in the world of stock markets. Even if you pick the very best company and it is on a confirmed uptrend, the share price can still fall to a downtrend suddenly if market-shaking news is announced. You can never predict when the next scandal, financial disaster or war will erupt.

So, no matter how confident you are in an investment, <u>never put everything you have into it</u>. Never stubbornly hold on to it if the stock price moves against you. There is always a probability that the investment will fail. This is the most common mistake that kills untrained investors.

In Chapter 9, you are going to learn about calculating the risk-reward probability of each investment and managing your risk. For example, although the 50 and 150 DMA crossover signal is very useful for determining trends, it only results in a successful investment 60% – 65% of the time. As long as you cut and minimize your losses when it fails the other 35 – 40% of the time and maximize your profits 60% – 65% of the time, you will end up much richer. This is known as risk management and we will cover this in greater detail in Chapter 9. For now, let's move on to the next chapter where you will learn how create a passive income stream through Real Estate Investment Trusts (REITS).

SEVEN
CHAPTER

Becoming a Landlord of Multiple Properties with REITs

Becoming a Landlord of Multiple Properties with REITs

CHAPTER**SEVEN**

Congratulations! Over the last few chapters, you have learned how to buy and own the most successful businesses that will grow your wealth over time. However, remember that businesses are not the only income-generating assets that can make you rich.

The richest people in the world also own another great money-making asset — real estate! Tycoons like Li Ka-shing, Donald Trump and the late Ng Teng Fong have made billions from owning and leasing real estate all over the world.

As population increases around the world and demand in land-scarce cities keeps rising, real estate will always keep appreciating in value over the long term. This is what makes real estate another great vehicle for beating inflation and growing your wealth.

Figure 7.1: US House Price Index 1975 – 2012[1]

[1] FRED, Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, "All-Transactions House Price Index for the United States", Federal Housing Finance Agency, http://research.stlouisfed.org/fred2/series/USSTHPI, accessed March 06, 2013.

Figure 7.2: Singapore Private Residential Property Price Index 1960 – 2010[2]

Although real estate prices may not appreciate as fast as share prices of companies, real estate has the big advantage of providing a regular stream of passive rental income. Investing in real estate, in addition to company stocks, also lowers your risk through diversification.

Imagine Becoming a Landlord of Multiple Properties

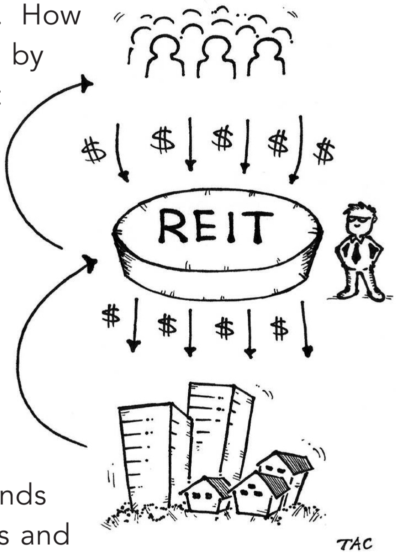
Imagine being the owner of several properties and earning a constant stream of rental income every month. When you own enough properties that generate enough passive income to cover your monthly expenses, you will become financially free.

It sounds like a great plan but many people believe that this is a dream that is way beyond their reach. In countries like Singapore where a 4-room government-subsidized apartment can cost US$350,000 – US$400,000, most people can only afford to buy their own home and a second apartment at the very most. Most people do not have hundreds of thousands of dollars of cash to afford the down payments for several more properties.

[2] Chart source for 1960 to 2006: REDAS, "Tracking Private Residential Property Price Index over the Years", December 15, 2006. Data source for 2007 onward: Urban Redevelopment Authority, Singapore.

You Can Own Multiple Properties through Real Estate Investment Trusts (REITs)

The great news is that you can actually start investing in multiple properties and earn passive rental income right away, even with just a few hundred dollars. How is this possible? The answer is by investing in Real Estate Investment Trusts (REITs).



A REIT is a special type of trust company that you can buy shares in. You can invest as little as $600 to as much as a few million dollars to acquire these shares (called units). The REIT (managed by a REIT manager) will pool together all the funds invested by thousands of investors and use it to buy real estate assets like apartments, shopping malls, hospitals, offices, industrial parks, etc.

The REIT manager will then lease out the portfolio of properties in order to collect a stream of rental income. All this income collected will then be distributed back to unit holders of the REIT. In countries like Singapore, REITs are required to distribute 90% of their income back to unit holders in the same year in which the income was earned.

The REIT manager's job is also to maximize and increase the income generated by the portfolio of properties every year. In order to do so, the manager would occasionally renovate the properties, increase the rent charged to tenants or sell certain real estate assets to reap the capital gains.

In other words, REITs provide a way for small investors to collectively own a portfolio of the best real estate assets around the world and share the stream of rental income. The best part is that it allows you to be a landlord without the hassle of taking huge mortgage loans, managing tenants and maintaining the properties. All this work is done professionally by the REIT managers.

REITs are listed on the stock exchange and can thus be bought and sold easily like shares of regular companies. Just like company stocks, REIT shares have prices that are determined by supply and demand.

When investors are very optimistic, the increased demand for shares will drive REIT prices up. Sometimes, the share price of the REIT can be higher than the market value of the property owned by the REIT. This is when the REIT becomes overpriced.

At other times, fear of an economic recession can cause investors to sell shares in REITs, causing prices to fall. In certain instances, the share price of REITs may be much lower than the market value of the property it owns. This makes the REIT undervalued and very attractive to own.

Although the price of REITs can go up and down, they are generally less volatile than the stocks of most companies. This is because REITs are backed by physical property and continue to pay shareholders income even during bad times.

REITs Offer the Highest Passive Income among All Asset Classes

If your strategy is to earn a constant stream of passive income, then no other asset class beats REITs. REITs offer the highest dividend yield (in the case of REITs, this is called **'distribution yield'**) as compared to bank deposits, stocks and bonds. REITs usually offer distribution yields of 5% – 8%. In other words, for every $100 invested, you get a cash payout of $5 – $8 per year. These cash payouts may even increase every year as the REIT acquires more properties and raises the rent that tenants have to pay.

Chart 7.3: Comparing Yields of Different Asset Classes

In comparison, savings and fixed deposit accounts pay an interest rate of less than 1% and bonds yield an average of 3.5%. Historically, the average dividend yield for stocks has been only 3% – 4%. The average yield for the S&P 500 index and Straits Times Index (STI) is 2.8% and 3.7% respectively.

While stocks of certain companies also pay cash dividends, these payments are not as regular as the cash payout by REITs. Companies are not legally required to pay out their profits as dividends. The stocks you own may or may not pay you dividends, depending on the decision of the management. However, REITs are legally obliged to pay 90% of their income to you as dividends in order to be tax-exempted.

Comparing REITs to Buying Physical Property

How does investing in REITs compare to buying physical property? There are four key advantages that REITs have over owning physical property.

1) Liquidity and Transaction Costs

Property is typically a very illiquid asset. What this means is that it cannot be sold quickly to raise cash. If you happen to need cash urgently or if real estate prices are falling because of the onset of a recession, you cannot sell physical property immediately.

It typically takes a few months to put your property on the market and wait for buyers to make you an offer. There are also a lot of transaction costs involved in buying and selling real estate — lawyer fees, agent commissions, insurance and stamp duty can amount to several thousands of dollars. You need to have deep pockets and strong holding power when investing in physical property.

On the other hand, REITs give you the advantages of owning property and earning rental income with the flexibility of stocks. Since REITs are listed on the stock market, they can be sold within seconds and be converted to cash within three days. There is also minimal transaction costs involved.

2) Tax Savings

There are quite a bit of taxes involved in property investments. When you buy a property, you have to pay tax known as 'stamp duty'. Every year, you have to pay property tax. In addition, you have to pay taxes on the rental income you receive from your tenants.

REITs, on the other hand, are tax-free vehicles. REITs do not have to pay stamp duty when purchasing property. REITs do not have to pay taxes on the income that they distribute to shareholders. In most countries, like the US, only shareholders have to pay tax on the dividends they receive. However, in some countries like Singapore, shareholders are not required to pay taxes on dividend income received from REITs.

3) Professionally Managed

There is a lot of work involved in managing the properties that you buy and rent out. You have to maintain the properties, renovate, look for tenants, manage them and chase for payments. REITs are hassle-free as professional REIT managers are the ones managing the properties.

4) Greater Diversification

Given the high prices of real estate, most people would only be able to afford a second or third investment property. If you happen to invest in a location that does not appreciate in value or a place where you are unable to find tenants, it would be a costly mistake.

REITs enable you to diversify your risks by investing in a portfolio of multiple properties in different locations and in different countries. Besides investing in residential property, REITs allow you to invest in offices, retail malls, hospitals, hotels and even industrial parks.

Table 7.4: Comparison of Physical Property and REITs

Physical Property	Real Estate Investment Trusts
Illiquid and high transaction costs	Liquid and low transaction costs
Stamp duty Tax on rental income	No stamp duty No tax on rental income
Need to manage tenants and maintain property	Professionally managed by REIT manager
Own 1 – 3 properties	Own a portfolio of diversified properties in different markets
Rental yield of 3% – 4%	Distribution yield of 5% – 8%
Leverage without the risk of top-ups and margin calls if the property value falls	Leverage with the risk of top-ups and margin calls if the REIT value falls

Leverage — The Advantage of Physical Property

You may wonder, "With the many advantages that REITs have, why bother investing in physical property?" Well, there is one big advantage that physical property has over REITs! When you invest in physical property, you are able to borrow 80% – 90% of the property value from the bank. By making a down payment of only 10% – 20%, you enjoy the advantage of leveraging your returns.

For example, imagine that you decide to buy an apartment for $1,000,000. You are only required to make a down payment of $200,000 (20%) and can take out a mortgage loan from the bank for the remaining $800,000 (80%). Of course, there would be additional transaction costs and fees (e.g. lawyer fees, stamp duty insurance, property tax, interest, etc.) that could work out to $48,000+. Nonetheless, you are able to own a $1,000,000 property with just $200,000+.

If your property price increases by 20% to $1.2 million in a year and you sell it for the higher amount, you will bag a profit of $152,000 ($200,000 profit - $48,000 transaction costs). However, your actual rate of return is not 20%, but much higher. Since you only invested $200,000 into the asset, your rate of return is $152,000 ÷ $200,000 = 76%. This is the effect of **leverage**! It multiplies your return from 20% to 76% (almost 4 times more).

Of course, the opposite can happen. If your property price drops by 20% during a recession, you would suffer an unrealized loss of $200,000. Since you invested $200,000+, you would have incurred a leveraged loss of almost 100% of your money. However, as long as you do not sell the property at this depressed price, you would not actually realize the loss. As long as you continue to pay your monthly installments with interests, the bank will allow you to hold the property for the long term until the price recovers.

In the case of REITs, banks will not be willing to loan you 80% of the REIT value to make a purchase. You usually have to purchase shares of the REITs in cash. You therefore do not enjoy the advantage of leverage that owning a property gives you.

However, there is a way you can leverage your returns from REITs and shares of companies. In Chapter 10, I am going to show you a way you can borrow shares on margin or to use derivatives like CFDs to buy $100,000 worth of shares/REITs with a capital of just $10,000. However, bear in mind that leveraging with stocks and REITs are much riskier than leveraging with property.

If property prices fall, banks will usually not ask you to pay the difference between your purchase price (e.g. $1 million) and the lower market price (e.g. $800,000). But in the case of REITs and shares, if their prices fall and if you have borrowed money to invest in them, the broker who loaned you the money would require you to top up the losses in cash. If you are not able to meet this 'margin call', they will force you to sell your stocks at the lower prices. This is therefore a high-risk approach that should only be used by experienced/professional investors. You will learn more about this in Chapter 10.

Becoming Financially Free with REITs

Many people set the goal of becoming financially free at some point in the future. Financial freedom is achieved when the passive income you receive exceeds your monthly expenses. Once this happens, you have the choice to stop working and maintain your lifestyle for the rest of your life.

Some people I know have become financially free from investing in rental properties and/or REITs. Once the rental income/dividends you receive a year is able to cover your annual expenses, you will be free to do what you love and have no more financial worries and pressure. Here are the steps to planning your financial freedom.

Step 1: Determine Your Annual Expenses

The first step is to calculate your average expenses for a year. For example, if you spend $4000 per month on average, your annual expenses would be $48,000.

So, you would need a passive income of $48,000 per year to be financially free.

Step 2: Determine the Value of REITs Required to Generate the Income Required

If REITs pay out an average distribution yield of 6%, then calculate the market value of REITs required to generate the annual passive income required. Take your annual passive income and divide it by 6%.

In this case, $48,000 ÷ 6% = $800,000

You would need to have $800,000 worth of REITs to generate $48,000 worth of passive income ($800,000 × 6% = $48,000).

Step 3: Calculate How Long It Will Take to Achieve Your Target

So, how long will it take for you to accumulate $800,000 worth of REITs? You will need to use a financial calculator to help you work out this figure.

Assuming:
You have $15,000 to begin investing immediately
You save and invest $1,500 per month into a portfolio of REITs
The REITs selected have an average annual growth rate of 12%
The number of years required would be = 15 years

(Present value = $10,000, future value = $800,000, return = 12%, monthly payment = $1,000)

Step 4: Start on Your Investment Plan

Once you have your plan in place, start taking action by saving and investing regularly. When you are ready to relax and retire in 15 years, you will have a huge portfolio of REITs to generate the passive income you need for the rest of your life.

Types of REITs You Can Invest In

Not all real estate assets are the same. The risks and returns from investing in an office building are very different from the risks and returns from investing in a shopping mall. There are different types of REITs that invest in different categories of real estate.

Understanding the characteristics of each REIT type is essential in knowing what best suits your investment portfolio. There are six main types of REITs. They are 1) office REITs, 2) retail REITs, 3) industrial REITs, 4) hospitality REITs, 5) health care REITs and 6) residential REITs. Countries like Singapore offer one of the best values for REITs in terms of high distribution yield and price stability. Therefore, most of the examples I would give would be REITs listed in Singapore. The only exception would be residential REITs that are only available in countries like the United States.

1) Office REITs

Photo credit: Ian Ho

Office REITs are REITs that own and operate office buildings. They are highly cyclical (i.e. affected by changes in the economy) because they lease space to other companies. During economic booms, many companies grow and expand, increasing the demand for office space. This allows office REITs to raise their rents, increase their occupancy rates and enjoy higher rental income.

During economic contractions, many companies cut down operations to save money, decreasing the demand for office space. This causes rents and occupancy rates to fall and rental income to decline as well.

Offices are also less differentiated as compared to other properties like retail malls. If the REIT raises rent too fast, tenants can easily move to a less expensive office space. Therefore office REITs are limited by how high they can raise their rent.

Since office REITs are relatively more risky and have less flexibility in raising rent (as compared to retail properties), investors tend to demand a higher yield to compensate for this risk.

Here are some of the popular office REITs you can look at:

- **CapitaCommercial Trust** (listed on Singapore Exchange)
  Property portfolio: Capital Tower, Six Battery Road, One George Street, HSBC Building, Raffles City Singapore, Bugis Village, Wilkie Edge, Twenty Anson, Golden Shoe Car Park, CapitaGreen, etc[3].

- **Keppel REIT** (listed on Singapore Exchange)
  Property portfolio: Bugis Junction Towers, Marina Bay Financial Centre Phase 1 (ownership interest 33.33%), Ocean Financial Centre (ownership interest 99.99%), One Raffles Quay (ownership interest 33.33%), Prudential Tower (ownership interest 92.8%), 275 George Street (Brisbane, Australia) (ownership interest 50%), etc[4].

[3] Source: www.cct.com.sg (accessed on 14 February 2013)
[4] Source: www.keppelreit.com (accessed on 14 February 2013)

2) Retail REITs

Retail REITs are REITs that own and operate retail properties like shopping centres and shopping malls. In countries like the US where there are numerous shopping malls and lower population density, retail REIT prices and income are also sensitive to the economic cycle.

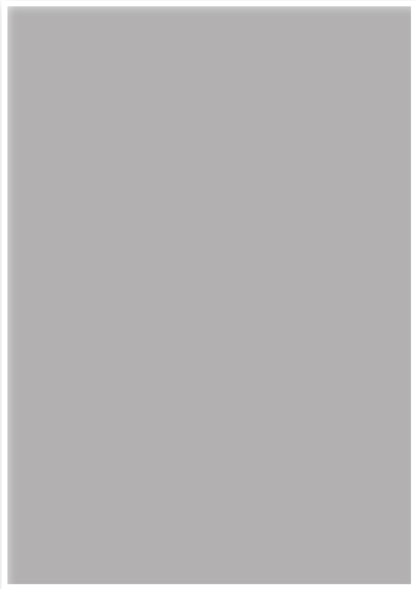


Photo credit: Ian Ho

However, in countries like Singapore, where population density is high and where there is a limited supply of land for retail malls, retail REITs are much more resilient to changes in the economy.

In Singapore, retail REITS are relatively recession-proof. Even in an economic downturn, major shopping malls are able to fully lease out their retail spaces. The distribution income for retail REITs is therefore a lot more stable. Retail REITs are also able to raise rent after they have carried out major renovations on their malls.

Due to the scarce land allocated to retail developments, there is a limited supply of new malls that developers can build. This tight supply ensures that retail property prices remain resilient, even in a downturn. Retail REITs have the potential to appreciate more than office REITs but may offer lower distribution yields.

Here are some of the popular retail REITs you can look at:

- **CapitaMall Trust** (listed on Singapore Exchange)
  Property portfolio: The Atrium@Orchard, Bugis Junction, Bugis+, Bukit Panjang Plaza, Clarke Quay, Funan DigitaLife Mall, IMM Building, Junction 8, JCube, Lot One Shopper's Mall, Plaza Singapura, Raffles City, Rivervale Mall, Sembawang Shopping Centre, Tampines Mall[5]

- **CapitaRetail China Trust** (listed on Singapore Exchange)
  Property portfolio: 9 malls in Beijing, Shanghai, Wuhu, Wuhan, Zhengzhou and Huhhot[6]

- **Starhill Global REIT** (listed on Singapore Exchange)
  Property portfolio: Singapore: Wisma Atria, Ngee Ann City Malaysia: Starhill Gallery, Lot 10, Malls in Australia, Japan and China[7]

3) Industrial REITs

Industrial REITs own and lease out industrial properties that include light industrial properties, factory space, warehouses, business parks and distribution centres. Majority of these properties have short leases of 30 – 60 years and will thus not appreciate in value very much.

There is also limited potential for industrial REITs to enhance their properties through renovation and raise rental rates. Like office REITs, industrial REITs are highly sensitive to the economy.

[5] Source: www.capitamall.com (accessed on 14 February 2013)
[6] Source: www.capitaretailchina.com (accessed on 14 February 2013)
[7] Source: www.starhillglobalreit.com (accessed on 14 February 2013)

During recessions, businesses suffer and scale back operations. This causes the occupancy rate for industrial properties to fall (by up to 30%) and distribution income to decline.

As a result, investors usually demand a higher yield from industrial REITs to compensate for the risks and limitations in price appreciation.

Here are some of the popular industrial REITs you can look at:

- **Ascendas REIT** (listed on Singapore Exchange)
  Property portfolio: 23 business & science parks, 20 hi-tech industrials, 31 light industrials, 2 flatted factories, 23 logistics & distribution centres, 2 warehouse retail facilities[8]

- **Mapletree Logistics Trust** (listed on Singapore Exchange)
  Property portfolio: 53 in Singapore, 13 in Malaysia, 8 in Hong Kong, 7 in China, 22 in Japan, 7 in South Korea[9]

- **Mapletree Industrial Trust** (listed on Singapore Exchange)
  Property portfolio: 3 business parks, 1 hi-tech industrial, 8 light industrials, 27 flatted factories, 1 stack-up building[10]

4) Hospitality REITs

Hospitality REITs own and lease properties to hotels and serviced residences. These REITs normally negotiate long-term leases with the hotel operator (e.g. Orchard Hotel).

The hotel operator usually pays a fixed rental with a variable

[8] Source: www.a-reit.com (accessed on 14 February 2013)
[9] Source: www.mapletreelogisticstrust.com (accessed on 14 February 2013)
[10] Source: www.mapletreeindustrialtrust.com (accessed on 14 February 2013)

component that depends on the hotel's financial performance. Hospitality REITs are also highly sensitive to the economy and the tourism industry.

Here are some of the popular hospitality REITs you can look at:

- **CDL Hospitality Trusts** (listed on Singapore Exchange)
  Property portfolio (hotels): Orchard Hotel, Grand Copthorne, Waterfront Hotel, M Hotel, Copthorne King's Hotel, Studio M Hotel, Novotel Singapore Clarke Quay, etc[11].

- **Ascott Residence Trust** (listed on Singapore Exchange)
  Property portfolio (serviced residences):
  Singapore: Ascott Raffles Place Singapore, Citadines Mount Sophia Property Singapore, Somerset Liang Court Property Singapore, New Cairnhill Serviced Residence
  Also in Australia, China, Indonesia, Japan, the Philippines, Vietnam, France, United Kingdom, Belgium, Germany, Spain[12]

5) Health Care REITs

Health care REITs own health care facilities that are leased to health care providers like hospitals, nursing homes and medical offices. Their rental income is the most stable among all the REIT types. Even during the worst recessions, hospitals do not go out of business and move out of their premises. Heath care providers also sign long-term master lease agreements. This reduces the volatility of the rental income received.

Health care REITs usually offer one of the highest distribution yields but one of the lowest capital appreciation and income growth. They are suitable for investors who want certainty and less volatility.

[11] Source: www.cdlht.com (accessed on 14 February 2013)
[12] Source: www.ascottreit.com (accessed on 14 February 2013)

Once again, here are some of the popular health care REITs you can look at:

1) **First REIT** (listed on Singapore Exchange)
   Property portfolio:
   Singapore: Pacific Healthcare Nursing Home @ Bukit Merah, Pacific Healthcare Nursing Home II @ Bukit Panjang, The Lentor Residence
   Also in Indonesia and South Korea[13]

2) **Parkway Life REIT** (listed on Singapore Exchange)
   Singapore: Mount Elizabeth Hospital, Gleneagles Hospital, Parkway East Hospital
   Also in Japan and Malaysia[14]

6) Residential REITs

Finally, we have residential REITs that own and operate multi-family rental apartment buildings as well as manufactured housing. There are no REITs that invest in residential property in Singapore because of the high level of home ownership in the country. Also, residential rental yields are just too low (2% – 3%) for Singapore-based REITs to be interested to own them.

However, residential REITs can be very profitable in cities (e.g. New York, Los Angeles, London, Japan) where many families cannot afford housing and rent their homes instead.

You should look to investing in REITs that own properties in cities where there is increasing population and job growth. Generally, when there is a net inflow of people to a city, it's because jobs are readily available and the economy is growing. As long as the apartment supply in a particular market remains low and demand continues to rise, residential REITs should do well.

[13] Source: www.first-reit.com (accessed on 14 February 2013)
[14] Source: www.plifereit.com (accessed on 14 February 2013)

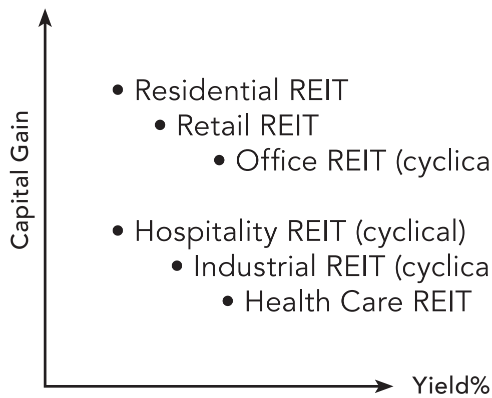
Here are some popular US residential REITs to look at:

- **Home Properties, Inc. (HME)**
  (listed on New York Stock Exchange) A multi-family REIT that operates largely along the East Coast of the US. It owns and operates 124 communities with 43,489 apartment units[15]

- **Sun Communities, Inc.**
  (SUI) (listed on New York Stock Exchange)
  This REIT's portfolio comprises about 63,600 developed sites. It owns and operates 173 manufactured housing communities in 19 states, concentrated in the Midwestern and southeastern United States[16]

Figure 7.5 below shows how the six different REITs compare with regard to capital gain and distribution yield.

Figure 7.5: Comparing REITs on Capital Appreciation and Yield



Health care and industrial REITs have the highest yields but the lowest potential for capital gains. On the other hand, retail, residential and office REITs have relatively lower yields but greater potential for price appreciation.

[15] Source: www.homeproperties.com (accessed on 14 February 2013)
[16] Source: www.suncommunities.com (accessed on 14 February 2013)

The 6 Screens for Selecting Winning REITs

Now you know the advantages of owning REITs and the variety that is available for you to invest in. Next, I am going to show you how to select the most profitable and stable REITs to add to your portfolio.

Just like companies, not all REITs are good enough to invest in. You must learn how to avoid investing in subpar REITs that have overly high levels of debt and inconsistent or declining income for distribution. Here are six screens for finding the best REITs.

Criterion #1: High Distribution Yield (At Least 5%)

(Note: 'distributions' and 'dividends' can be used interchangeably)

The primary reason we invest in REITs is to receive distribution payments regularly (at least every quarter).

It therefore makes sense to invest in REITs that have the highest distribution yield of its category. However, a rule of thumb is to invest in REITs with a distribution yield of at least 5%.

$$\text{Distribution yield} = \frac{\text{Total annual distribution}}{\text{REIT price}} \times 100\%$$

For example, Keppel REIT's total distribution for the last financial year (2011) was $0.0708. Its current price is $1.11.

Therefore, Keppel REIT's distribution yield is

$$\frac{\$0.0708}{\$1.11} \times 100\% = 6.3\%$$

Notice that when the price of the REIT increases, the distribution yield falls. For example, if Keppel REIT's price increases to $2 and the distribution remains the same at $0.0708, the yield will fall to 3.54%. If the distribution increases together with the REIT price, then the yield will stay the same. So, a low distribution yield (less than 5%) tells you that the REIT is currently too expensive to buy.

REIT	Distribution Yield (as of 30 May 2012)
CapitaMall Trust	4.69%
Suntec REIT	6.86%
CapitaRetail China Trust	5.84%
Starhill Global REIT	5.64%

The above table compares four Singapore retail REITs and their distribution yields. Suntec, CapitaRetail and Starhill Global have yields above 5% while CapitaMall Trust seems expensive at its current price (yield less than 5%). Suntec REIT seems to have the highest distribution yield at 6.86%.

Criterion #2: History of Consistent Growth in DPU

Distribution yield is not the only criterion we need to look at. You also need to ensure that the REIT you invest in has a history (at least 4 – 5 years) of consistent increase in their **distribution per unit** (DPU) (i.e. dividend per share).

Let's take a look at Suntec REIT's distribution per unit over the last 4 years. (You can get all this data from the REIT's annual report.)

Year	Total Annual Distribution per Unit
2008	$0.082
2009	$0.117
2010	$0.098
2011	$0.099

You can see that Suntec REIT increased its distribution per unit every year except for a dip from 2009 to 2010. This is understandable, given the crash in the real estate market due to the US subprime financial crisis. If not for the crisis, Suntec REIT seems to have a good track record of increasing its payment to shareholders.

Criterion #3: High Expected DPU Growth over Next 1 – 2 Years
Thirdly, you have to ensure that the REIT you buy is expected to generate increased income and distribution in the next 1 – 2 years. This comes from expected increase in property prices, increase in rental or acquisition of new properties.

Cyclical REITs like office, industrial and residential REITs should not be bought when the economy is entering a recessionary phase. This is a time when these property prices and rental income are expected to decline. They should only be bought when the economy is recovering from a recession or in an expansionary phase.

How would you know the potential of the REIT sector you are looking at? You can leverage on the hours of research done by professional analysts by reading their analyst reports on the outlook for each sector. Instruct your broker to send you these reports. Alternatively, you can go to www.sreit.reitdata.com and www.mreit.reitdata.com to view Singapore and Malaysia REIT analyst reports respectively. For US REITs, you can go to www.morningstar.com.

Criterion #4 Low Gearing Ratio (< 40%)
Since REITs must pay out 90% of their income in dividends, most REITs can only acquire new properties by taking bank loans. When a REIT takes on too much debt, it exposes itself to interest rate risk and even default risk (when it is unable to service the repayments).

A REIT that has too much debt would be highly affected by interest rate changes. When interest rates increase, the REIT will have to pay higher interest on its loans, thereby decreasing its net income and dividends. This will cause the price of the REIT to fall. Conversely, falling interest rates will positively benefit these REITs.

In the worst-case scenario, a REIT may take on so much debt that it becomes unable to service its loans. In such cases, the REIT may have to ask investors to invest more money in the form of a rights issue or be forced to sell its properties.

To know if a REIT is taking on too much debt, you need to look at its **gearing ratio** (also known as 'debt-to-asset ratio').

$$\text{Gearing ratio} = \frac{\text{Total debt}}{\text{Total assets}} \times 100\%$$

The higher the gearing ratio, the riskier the REIT. As a rule of thumb, if a REIT has a gearing ratio above 40%, it is taking on too much debt and hence, too risky. In the case of Suntec REIT, you can check its latest financial report (FY 2011) that states that its gearing ratio is 37.3%.

Figure 7.6: Suntec REIT Consolidated Balance Sheet (FY 2011)[17]

Criterion #5: REIT Stock Price Is Fairly Valued

The next criterion to look at is the REIT's **net asset value** (NAV) per share. This is the market value of all the properties owned by the REIT after deducting its total liabilities. In a sense, this is the "intrinsic value" of the REIT.

As an investor, you would want to buy a REIT at a time when its price is below its NAV (undervalued). Such opportunities arise when there is a lot of pessimism in the market. At the same time, when the price has risen too high above its NAV (overvalued), you may want to avoid buying the REIT.

[17] Setting the Stage, Suntec Real Estate Investment Trust: Annual Report 2011, 27 March 2012

You can find a REIT's NAV by looking at its latest financial reports. From the same 'Extract of Suntec REIT's Annual Report' shown under Criterion #4, you can see that Suntec REIT's NAV per share is S$1.99.

Suntec REIT's share price at the time of my writing (30 May 2012) is S$1.23, making it undervalued and very attractive.

Criterion #6: REIT Must Be on a Confirmed Uptrend

Finally, it is also important to look at the charts and ensure that the REIT's price is on an uptrend. Just like what you have learned about stocks, invest at a time when the 50 DMA is above the 150 DMA and both moving averages are sloping upward.

Avoid buying a REIT when it is on a downtrend as pessimism in the market will keep pushing the price lower. Always wait for a reversal to an uptrend before making your entry.

From Chart 7.7, you can see that Suntec REIT has just reversed to an uptrend at the price of $1.23.

Chart 7.7: Suntec REIT Chart 2010 – 2012

Credit: www.chartnexus.com

Now that you have learned the essentials of how to select, analyze and invest in REITs to generate passive income for your portfolio, it is time to learn how to build a winning stock portfolio!

EIGHT
CHAPTER

Building a Winning Stock Portfolio

Building a Winning Stock Portfolio

CHAPTER**EIGHT**

"How many different stocks should I buy at any one time?"
"What kind of stocks should I include in my portfolio?"
"Are some stocks much riskier than others?"
"How do I minimize my risks while maximizing potential returns?"

Now that you have learned the specific steps of how to select the stocks of winning companies and to use technical analysis to catch them on their uptrends, it is time for you to learn about the different kinds of stocks that you can invest in and what you should include in your portfolio in order to maximize your potential returns while minimizing your risks!

Defensive Stocks Versus Cyclical Stocks

As you would realize, there are many different kinds of businesses with very different characteristics. Some businesses are more recession-proof while others are very dependent on the health of the economy. Some businesses may be in a slow-growing industry while others are growing rapidly. As a result, the stocks of these companies also have unique characteristics.

Some stocks are more risky and volatile than others, but may have much higher potential for gains. You must learn the characteristics of the kind of stocks you are investing in.

In this chapter, you are going to learn how to classify stocks into different categories and to understand the risks and potential returns of each one. Firstly, stocks can be broadly classified into two groups: **defensive stocks** and **cyclical stocks**.

Defensive Stocks

Defensive stocks are stocks of companies that sell a product or a service that is a necessity. Whether the economy is doing well or in a recession, people will still have to buy their products. For example, during a recession, you will still have to purchase toothpaste, groceries, medication, water and electricity. I doubt you will stop brushing your teeth or stop buying toilet paper during bad economic times.

So, health care, utility and consumer staples companies will not see demand for their products fall much, even during a recession. They will still be able to increase or maintain their revenues and profits regardless of the bad times. Since their revenues and profits are more predictable, the prices of their shares tend to be relatively much more stable as well.

On the flip side, defensive companies tend to be in "boring businesses" that are in slow-growth industries. For example, will there be a huge increase in the number of people using toothpaste each year? Unlikely. Their growth is slow and steady and not as exciting as businesses selling revolutionary products like the iPhone.

Defensive stocks tend to have a low beta value. When the overall stock market (measured by the index) goes up by 10%, defensive stocks may rise less (e.g. 5%). At the same time, if the stock market plunges by 10%, defensive stocks will fall by a smaller amount (they may even rise at times). Therefore, defensive stocks outperform the market during market downturns and underperform the market during market rallies. Take a look at the stock chart of a typical defensive stock like Colgate-Palmolive (CL). Notice that the stock price chart tends to be consistently increasing, with minimal volatility.

Chart 8.1: Colgate-Palmolive (CL) 2007 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

Chart 8.2: Colgate-Palmolive (CL) Versus S&P 500 2007 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

If you compare Colgate-Palmolive (CL) with the S&P 500 index, you can see that CL outperformed the S&P 500 from 2007 – 2012. This was the period of the US subprime mortgage financial crisis (2007 – 2009) and the European debt crisis (2010 – 2012). During times of economic uncertainty, investors tend to put their money into defensive stocks that are perceived to be safer.

So, the best time to hold defensive stocks is when the market starts going into a downtrend and when you anticipate a recession coming. During stock market rallies and economic booms, defensive stocks tend to start slowing down.

If you are the kind of investor that does not like much volatility and are willing to get slightly lower returns over the long term, then you may want to hold more defensive stocks in your portfolio.

Here are the typical defensive sector stocks and the most successful companies within them:

US Defensive Sectors

- **Consumer Staples Sector**
  Procter & Gamble (PG), Walmart (WMT), Pepsico (PEP), Colgate-Palmolive (CL), Coca-Cola (KO), Kimberly Clark (KMB)

- **Health Care Sector**
  Johnson & Johnson (JNJ), Pfizer (PFE), UnitedHealth (UNH) WellPoint (WLP), Abbott Laboratories (ABT)

- **Utilities Sector**
  Duke Energy (DUK), Exelon (EXC), NextEra (NEE), Dominion Resources (D), Southern Co. (SO)

Singapore Defensive Sectors

- **Singapore Consumer Staples Sector**
  Raffles Medical, Super Group, Asia Pacific Breweries, Dairy Farm, Cerebos

- **Singapore Telecommunications Sector**
  SingTel, StarHub, M1

- **Other Singapore Defensive Stocks**
  ComfortDelGro, SMRT, Singapore Press Holdings, VICOM

Cyclical Stocks

The opposite of defensive stocks would be cyclical stocks. Cyclical stocks are stocks of companies that sell products or services that are a luxury as compared to a necessity. These include companies that sell cars, high-end retail, computers, houses and travel services. The sales and profits of these companies depend on whether the economy is doing well.

During economic expansion, people feel richer and tend to purchase more luxury goods. Businesses start to expand more rapidly and take on more loans (from banks), order more raw materials, purchase more computer and IT products, get more office space and manufacture more goods. Therefore, the stock prices of these cyclical companies tend to increase rapidly during such good times.

However, during an economic slump, consumers and businesses will reduce the purchases of these good and services. This is when the cyclical companies suffer huge falls in their sales and profits. As a result, their stock prices fall hard as well.

Therefore, cyclical stocks have a high level of correlation to the economy and the overall market (high beta). When the stock market rises, cyclical stocks will lead the way, rising even faster. When the stock market falls, cyclical stocks will come crashing down even harder.

You can pretty well guess that the best time to buy cyclical stocks is when the stock market starts to recover from the bottom of a downturn and when investors anticipate that the economy is bouncing back. The time to get out of cyclical stocks is when the economy starts to falter and a recession is looming. This is usually signaled when the stock market starts to decline from its highs.

Take a look at the stock chart of a typical cyclical stock like Caterpillar (CAT) and see how it compares with the S&P 500. CAT is a manufacturer of industrial equipment and the company's profits rise and fall with the global economy. You can see that when the S&P 500 (blue line) fell during 2008 – 2009, CAT's (black line) share price fell much more. At the same time, when the S&P 500 recovered from 2010 to 2012, CAT rose at a much faster pace.

Chart 8.3: Caterpillar (CAT) Versus S&P 500 2007 – 2012

CAT

S&P 500

Credit: www.thinkorswim.com, ProphetCharts®

So, what kinds of stocks are cyclical in nature? Here are the typical cyclical sector stocks and the most successful companies within them:

US Cyclical Sectors

- **Consumer Discretionary Sector**
  Home Depot (HD), Target (TGT), Lowe's (LOW), Nike (NKE), Walt Disney (DIS), Time Warner (TWX)

- **Technology Sector**
  Apple (AAPL), Google (GOOG), eBay (EBAY), Amazon.com (AMZN), Microsoft (MSFT)

- **Finance Sector**
  Citigroup (C), JP Morgan Chase & Co. (JPM), Bank of America (BAC), Goldman Sachs (GS)

- **Industrial Sector**
  Deere (DE), General Electric (GE), 3M (MMM), Caterpillar (CAT), United Technologies (UT)

- **Materials Sector**
  Dow Chemical (DOW), Nucor (NUE), Alcoa (AA), DuPont (DD), Monsanto (MON)

- **Energy Sector**
  Exxon Mobil (XOM), ConocoPhillips (COP), Chevron (CVX), British Petroleum (BP)

Here is a list of the different cyclical sectors and stocks in the Singapore stock market:

Singapore Cyclical Sectors

- **Singapore Consumer Discretionary Sector**
  F J Benjamin, OSIM International, Genting International, Hotel Properties, Banyan Tree, The Hour Glass, etc.

- **Singapore Banking and Real Estate Sector**
  UOB, DBS, OCBC, CapitaLand, UOL, CDL, Keppel Land, City Developments, etc.

- **Singapore Offshore & Marine Sector**
  Keppel Corp, Sembcorp Marine, Neptune Orient Lines (NOL), COSCO, etc.

- **Singapore Commodities Sector**
  Noble Group, Olam, CWT, Wilmar, Golden Agri-Resources, etc.

- **Singapore Industrial Sector**
  ST Engineering, Hyflux, Jardine Matheson, Sembcorp Industries, etc.

So is it important to know whether a stock is defensive or cyclical? You bet! When you learn about how to build a winning portfolio in this chapter, you have to know how to balance the number of cyclical and defensive stocks, depending on where you are in the economic cycle and how aggressive or risk-averse you want to be.

Seven Stock Investment Categories

Now that you have learnt the difference between cyclical and defensive stocks, I am going to take you one step further. I have found that to be a profitable investor, grouping stocks into defensives and cyclicals is not good enough.

In this chapter, I am going to show you how to invest with greater precision, by dividing stocks into seven specific categories. Again, stocks in each category have their own unique characteristics and risk-return profile. The following is an overview of the seven stock categories:

Category 1: Dividend cash cows (lowest risk, lowest potential return)
Category 2: Large cap predictables
Category 3: Large cap growths
Category 4: Deep cyclicals
Category 5: Turnarounds
Category 6: Small fast growers (highest risk, highest potential return)
Category 7: Exchange-traded funds (ETFs)

Before you invest in a stock, it is important to know what kind of stock it is.

Category 1: Dividend Cash Cows

Dividend cash cows are stocks of companies that pay high dividend yields but do not appreciate very much in price. These companies are usually market leaders in slow growth, mature industries.

A company usually pays a high dividend rate when they generate a huge amount of free cash flow and do not need the cash to grow and expand their operations anymore. As a result, they are able to return this cash to you as a shareholder in the form of a dividend.

Dividend cash cows are ideal for investors who invest with the primary aim of earning passive income. Many of my students who are retirees prefer to invest in this category. Although these stocks do not increase in price very much, they do not fall very much during a downturn either. They are therefore one of the safest kinds of stocks you can invest in.

Chart 8.4: SingTel 2009 – 2012

Credit: www.chartnexus.com

Chart 8.4 shows SingTel, a typical defensive dividend cash cow stock. During this 3-year period, SingTel's stock price rose from $2.50 to $3.20, at an annual compounded rate of return of 8.57%. However, during that period, you would have collected a total of $0.62 of dividends per share, bringing your total return to 15.18%. That is not too bad!

For dividend cash cows, I usually look for companies that have a dividend yield of 5% or more, belong to a defensive sector, and has a large capitalization (market cap of at least $10 billion). I would classify certain kinds of REITs as dividend cash cows as well. Some of my favorite dividend cash cows are:

Stock	Exchange	Dividend Yield (as of June 2012)
StarHub	Singapore	5.21%
SingTel	Singapore	4.66%
M1	Singapore	5.24%
CapitaMall	Singapore	4.23%
Suntec REIT	Singapore	6.05%
Maxis	Malaysia	4.89%
Malayan Banking (Maybank)	Malaysia	7.56%
Bank of China	Hong Kong	5.23%
Reynolds (RAI)	US	5.54%
Royal Dutch Shell (ADR)	US	4.94%

Note: Notice that Asian stocks, especially Singapore stocks, have the highest dividend yields in the world right now.

Category 2: Large Cap Predictables

This category is the favorite of legendary investor, Warren Buffett. These are stocks of large companies that sell a product/service that has highly predictable future sales revenue, profit and cash flows. A predictable product/service is one that is in a "boring business" and never goes obsolete.

Apple may be a very successful company today, churning out billions of dollars from its blockbuster products of iPhones and iMacs. However, can you be absolutely sure that Apple's products will continue to be the talk of the town 5 years from now? Of course not. Apple's future success is highly unpredictable. It is in an exciting but unpredictable business.

If it is able to continue to innovate breakthrough products, then its sales and profits will continue to increase exponentially and its share price will continue to skyrocket. However, if a competitor like Samsung, Microsoft or Google comes out with an even better phone, Apple may then lose a huge amount of market share and see its share price go into free fall.

This is exactly what happened to Nokia. Nokia used to be a market leader in phones and boasted a share price of $35. But after people started to dump their Nokia phones for Androids and iPhones, Nokia's share price has fallen to only $2.38!

On the other hand, can we be sure that 5 – 10 years from now, people will still eat at McDonald's, drink Coca-Cola, use their Visa credit card, brush their teeth with Colgate, get a bank loan from UOB, take the SMRT train to work and use StarHub mobile service to make a call? Of course!

These companies have products that will never (or are unlikely to) go obsolete. The Coke that is being sold today is the exact same beverage that was sold in 1886! This is why Warren Buffet invests in companies like Coca-Cola, Nike, Visa, Johnson & Johnson and Procter & Gamble. These are companies that are highly predictable and he can have the peace of mind to buy and hold them for the long term.

So, large cap predictable stocks are ideal for investors who like to buy, "close their eyes" and hold for the long term. They may not grow very fast, but they are the safest stocks you can buy! These are stocks that you can safely buy more to average down when their stock price falls during a recession, as you can be quite confident that their share price will bounce back eventually. However, as a value-momentum investor, it is a strategy that I do not use. I would still prefer to sell them when their price goes on a downtrend and buy them back at an even cheaper price when they bottom out and start a new uptrend.

Here are some of my favorite large cap predictable stocks:

Stock	**Exchange**
Colgate-Palmolive	US
Kimberly Clark	US
Procter & Gamble	US
Nike	US
McDonald's	US
Campbell Soup	US
SMRT	Singapore
VICOM	Singapore
Dairy Farm	Singapore
Asia Pacific Breweries	Singapore
StarHub/SingTel	Singapore

Note: StarHub and SingTel are both 'dividend cash cows' and 'large cap predictables'.

Category 3: Large Cap Growth

As the name suggests, large cap growth stocks are stocks of large companies that are growing rapidly (sales revenue and net profit increasing more than 20% annually). These growth stocks are usually technology stocks that are cyclical in nature.

Warren Buffett would never invest in technology stocks like Apple, Google, Baidu.com, Microsoft, eBay or Amazon.com because their future sales and profits are highly unpredictable! Their fortunes could rise and fall dramatically once there is a change in technology or consumer preferences. They all sell a product that can go obsolete very quickly if they do not continue to innovate aggressively.

So, does this mean that we should not invest in this kind of companies as well? Of course not! You would be missing out on some amazing investment opportunities if you did. I have personally made huge amounts of money investing in these large cap growth companies. Many legendary investors like George

Soros, Victor Sperandeo, William O'Neil and John Paulson have also made their billions investing in these super growth stocks.

The great thing about these growth stocks is that they can lead to very high returns and grow your wealth exponentially. For example, an investment in Apple would have seen your wealth grow by 582% over the last 4 years. An investment in Baidu.com would have given you a very nice 11.4-fold increase on your money over that same period (from $10 to $114 per share).

Chart 8.5: Apple (AAPL) 2009 – 2012

Credit: www.thinkorswim.com, ProphetCharts®

The thing about growth stocks is that you cannot buy, "close your eyes" and hold them for the long term. Due to their unpredictable nature, growth stocks can fall dramatically in price and never recover if their products become obsolete or demand for their product/brand falls. You have to make your money and sell once they reverse to a downtrend.

Unlike large cap predictable stocks, you should never, ever buy more to average down when the share price is falling. Imagine if you had bought more of Nokia (NOK) or Research In Motion (RIMM) (maker of BlackBerry) as it fell from grace — you would have lost everything! In Chart 8.6, you will see how NOK's stock price has fallen from $35 to $2.38 during 2007 – 2012.

Chart 8.6: Nokia (NOK) 2007 – 2012 — A Growth Stock Gone Bad

Credit: www.thinkorswim.com, ProphetCharts®

Here are some of my favorite large cap growth stocks:

Stock	Exchange
Apple	US
Google	US
Amazon.com	US
eBay	US
Visa/MasterCard	US

Note: Visa and MasterCard are classified under both 'large cap growth' and 'large cap predictable'. While both companies are growing rapidly, you can bet that people will still be using credit cards 5 – 10 years from now.

Category 4: Deep Cyclicals

This category of stocks is relatively more risky but you can make huge profits from them if you know how to invest in them (and sell for profits) at the right time.

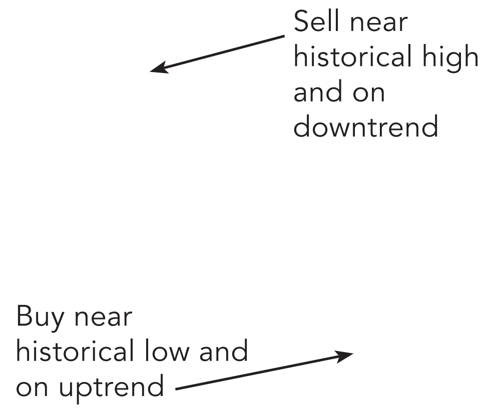
Deep cyclical stocks are stocks of companies that are in capital-intensive and highly cyclical industries. This includes airline companies, shipping companies, real estate companies, commodities companies, construction companies, banks and manufacturers.

Since these companies are highly capital-intensive, they are not able to respond to demand changes quickly. For example, during a recession, when demand for shipping/chartering services drop, shipping companies like Neptune Orient Lines still have to pay millions of dollars each month to maintain their ships, equipment and labor force. They are not able to cut all their fixed costs as easily. As a result, they will lose millions of dollars during such recessions. When the economy recovers to full expansion, companies like Neptune Orient Lines will then start to make lots of money again!

So, deep cyclical stocks make huge profits during economic booms and huge losses during recessions. What do you think their share price looks like? Unlike large cap predictable or large cap growth stocks whose share price is able to increase steadily over the medium to long term, deep cyclical stocks go on huge uptrends and huge downtrends!

As a result, you should <u>never, ever</u> buy and hold deep cyclical stocks for the long term. All the profits you make during one uptrend would be lost during the next downtrend. You should only buy these stocks when they are losing money (when their stock price hits rock bottom) and start to sell them for profits when their stock price is at its historical high (when it is making huge profits).

Chart 8.7: CapitaLand (Deep Cyclical Stock)



Credit: www.chartnexus.com

Look at the chart of CapitaLand, one of the largest real estate development companies in Asia. You can see that the best time to buy would be when it is near the historical low and to sell for profits when it is near the historical high. You should also make use of indicators like moving averages to help you enter when the uptrend starts and exit when it starts to go on a downtrend.

I love to start buying deep cyclical stocks when they are near the bottom of their chart ranges and see my investment increase 100% – 300% when the economy starts to recover. At this time (June 2012) during the European debt crisis, many deep cyclical stocks like Alcoa (AA), Neptune Orient Lines (NO3), Caterpillar (CAT), Noble Group (N21) and Keppel Corp (BN4) are selling near their historical low and could present a great investment opportunity once they start their new uptrend.

Category 5: Turnarounds

Have you ever read about well-known companies that have been hit by lawsuits, scandals, product failure, public relations disasters, industry recessions or some kind of bad news that hits its bottom line? Of course you have. Think of British Petroleum's (BP) oil well explosion in 2009, Citigroup's huge losses during the 2008 subprime crisis or Hewlett Packard's (HP) recent 2011 restructuring issues and the departure of its former CEO.

No matter how great a company is, it will always be hit by some kind of bad news from time to time. That is when the company's stock price will fall by 20% – 90%, depending on the severity of the problem.

When you invest in good companies at a time when their stock price has taken a hit, you are investing in 'turnaround' stocks. When you invest in such companies, you must always be sure that the company's problems are <u>temporary</u> and that its sustainable competitive advantage and ability to recover its profits remain intact. This is not always easy to do and hence, investing in turnaround stocks is quite risky. If they do turn around, you stand to double/triple your money. If they never recover, you may stand to make a loss.

One of my best turnaround investments was in BP, back when its oil well in Macondo exploded, causing tons of oil to be spilled into the ocean. After being served billion dollar lawsuits for environmental damage, BP's share price fell from $60 to a low of $28. I saw that as an opportunity to buy a great company at a temporarily depressed price. I knew that the oil spill was a temporary problem and although the company may lose billions of dollars in damages, it would eventually make it all back. After all, it was (and still is) one of the largest oil & gas companies in the world and had the financial strength to survive through the crisis. I was well rewarded when BP's share price eventually rebounded to $50.

Here are my rules for investing in turnaround companies:

Rule 1: The company must be a large cap with sustainable competitive advantage. It must have the financial strength to withstand the temporary loss in profits.

Rule 2: The bad news must be temporary in nature and should not affect the company's sustainable competitive advantage and long-term economics. Never invest in companies hit by accounting scandals. They usually never recover. Think of Enron and WorldCom.

Rule 3: Only invest when the stock price has bottomed and started a new uptrend. Never invest when the stock price is falling. You never know how low it could go.

Category 6: Small Fast Growers

So far, all the stocks I have been talking about are large cap stocks (market capitalization of more than $10 billion). Large caps are usually market leaders in their industries, have wide economic moats and are extremely financially strong.

However, there are also great opportunities investing in small- (market cap less than $1 billion) or medium-sized companies (market cap $1 – $10 billion). Why would we want to invest in these smaller companies?

Generally, small- or medium-sized companies have even greater growth potential than large companies that are already market leaders in their industry. Imagine if you invested in Apple, Microsoft, Nike or McDonald's before they became world famous. If you invest in the right small cap, you could see your investment multiply a few hundred fold to a large cap.

While the idea seems exciting, small or medium companies are usually much riskier than established blue chip stocks. These smaller companies usually have narrow economic moats (they are not market leaders yet) and may be less financially strong. Many small caps have been known to go bankrupt or get delisted when they run into cash flow problems or are unable to pay their debts during a recession.

When you consider investing in small or medium cap stocks, always ensure that they dominate a niche, have little or no debt and have a healthy level of cash flow. I have personally made huge profits in small- or medium-sized companies like OSIM International, Goodpack, BreadTalk, Raffles Medical Group and FJ Benjamin. All the above-mentioned are small-or medium sized Singapore companies with huge potential for future growth.

Category 7: Exchange-Traded Funds (ETFs)

Whatever category of stock that you decide to invest in, you have to be willing to do your research to ensure that you are investing in a great business. You have to study the company's income statements, balance sheets, cash flow statements and stock charts to ensure that they meet the eight criteria for picking winning companies (that you learned in Chapters 5 & 6). Whatever stock you buy, you have to ensure that the price you pay is below the stock's intrinsic value. Remember that every company is subject to risk. Even if you invest in a great company like McDonald's, an unexpected mad cow disease outbreak could see you lose money if its stock comes crashing down.

If you're someone who does not have the time or inclination to study individual companies, then the best thing to invest in would be ETFs, as mentioned before. This final stock category is one of the easiest and relatively safest to invest in.

When you invest in ETFs, you are investing in a basket of hundreds of companies. Hence you do not have to calculate an individual company's intrinsic value and be afraid of company-specific risks. When investing in ETFs, you only have to concern yourself with the ETF price trend — that is, to invest only on an uptrend and to sell when it starts to reverse to a downtrend.

Building a Winning Portfolio for Yourself

Now that you understand that not all stocks are built the same way and that different stock categories have different levels of risk and potential returns, you can begin to build a portfolio that will help you achieve your goals.

First, a few fundamental rules in building a winning portfolio:

1) Invest in a Maximum of 8 –10 Stocks at Any One Time

Unless you are a professional or semi-professional investor, I suggest that you hold no more than 8 – 10 different stocks at any one time. Remember that for every stock that you own, you have to regularly monitor its price trend, quarterly earnings and recent developments.

Many investors make the mistake of buying too many different counters in order to diversify their risks. In the end, they lose track and fail to give each stock the necessary attention it requires. That is when they start to make big mistakes and lose money. Imagine if you are a parent with 8 –10 children. Will you be able to look after each one as well? If you want to diversify, then buy an ETF instead and don't do it with too many individual stocks.

2) Never Invest in More than 2 Stocks from the Same Sector

Out of the 8 – 10 stocks that you own, avoid investing in more than 2 stocks from the same sector. This is because stocks in the same sector tend to have similar characteristics and move together. This is known as 'movement in sympathy'.

For example, when one oil company's stock goes down, all the other related oil stocks tend to go down as well. When BP's stock came crashing down during its oil spill disaster, stocks of ConocoPhillips, Shell and Exxon Mobil came down as well. When investment bank J.P. Morgan lost $2 billion in 2012 as a result of a bad trade, its stock came crashing down more than 30%. This caused stocks of related banks like Citigroup, Bank of America, Morgan Stanley and Goldman Sachs to crash as well.

If you had invested half of your portfolio into 4 – 5 banking stocks, then your portfolio would have taken a very big hit! If you had only 1 – 2 banking stocks and invested the rest of your money in other sectors like consumer goods, industrial, oil & gas or technology, the rest of them would have cushioned the blow.

3) Invest in No More than 3 Turnarounds and No More than 4 Deep Cyclicals and Small Fast Growers at Any One Time

Dividend cash cows, large cap predictables, large cap growths and ETFs are relatively less risky. On the other hand, turnarounds, deep cyclicals and small fast growers are much riskier.

My experience is that you should not invest in more than 4 deep cyclical stocks at one time. If the economy starts to slow down, your deep cyclical stocks will suffer the greatest falls. So you need at least half of your other stocks to be defensive in nature to cushion the fall. Usually, the 4 deep cyclical stocks I invest in would include a banking stock, a real estate stock, a commodities stock and an energy stock.

As for turnarounds and small fast growers, I would limit them to a maximum of 3 in my portfolio.

4) Always Keep at Least 10% of Your Portfolio in Cash

Another important rule is to never be fully invested into the market at any time. You should always keep a portion of your money in cash just in case. If the market happens to fall a little bit further, you will still have the ammunition to buy more of your favorite stocks at lower prices (provided they are still on an uptrend).

When the market is near the bottom of its cycle (when stocks are selling well below their intrinsic value), I would tend to be almost fully invested in the market, keeping only 10% of my portfolio in cash. Remember that when the market is near the bottom (when there is a lot of fear in the market), it is the point of maximum opportunity!

When the market is at the top of its cycle (when stocks are overpriced), I would start selling to lock in profits and raise cash. In fact, when the stock market starts reversing to a downtrend from a high, I would usually sell everything and keep 100% of my portfolio in cash. As an investor, you do not always have to be invested in the market. When the situation is not favorable, it is better to hold cash and wait for the right time to put your money back to work.

5) Your Portfolio Should Be Aligned to Your Lifestyle and Risk Appetite

Many people make the huge mistake of blindly following the investment advice and stock picks of experts. This is the worst thing you can do. The expert you listen to may have a totally different risk profile, investment holding period and lifestyle as compared to you.

For example, an expert may talk about investing in a stock like Transocean (RIG), which is a deep cyclical as well as a turnaround stock. If you buy this stock at the right time (near the bottom of its cycle), you could double/triple your money. If you buy this stock at the wrong time, you could lose half your money as well. This is the kind of stock that requires lots of monitoring of its trend and one that you cannot simply buy and hold. If you are a conservative investor that likes to buy and hold and does not have time to monitor trends regularly, this is a stock that you should not buy. You should buy a large cap predictable stock like McDonald's or Johnson & Johnson instead.

So the kind of stocks you invest in really depends on how much time you have, how much risk you are willing to take and how much returns you are aiming for. Presented below are four different kinds of portfolio for four different kinds of investors.

Portfolio A: Conservative
Includes: Only ETFs and REITs
For investors who have very little time and inclination to study financial statements and who fear picking the wrong stocks, their portfolio should consist only of ETFs and REITs. An example of an ETF/REIT- only portfolio is shown below:

Portfolio A
SPDR S&P 500 ETF (SPY)
SPDR S&P MidCap 400 ETF (MDY)
Technology SPDR ETF (XLK)
Morgan Stanley China A Share ETF (CAF)
Singapore STI ETF
Suntec REIT
Keppel REIT
Ascendas REIT
CapitaMall Trust

Portfolio B: Moderate

Includes: ETFs, REITs, dividend cash cows and large cap predictables

This portfolio includes not just ETFs and REITs but safer stocks like dividend cash cows and large cap predictables. Picking right large cap predictable and dividend cash cow stocks should further boost your returns. An example is shown below:

Portfolio B
StarHub (Singapore dividend cash cow)
Suntec REIT (Singapore REIT)
CapitaRetail China Trust REIT (Singapore REIT)
Dairy Farm (Singapore large cap predictable)
Super Group (Singapore large cap predictable)
Colgate-Palmolive (US large cap predictable)
Kimberly Clark (US large cap predictable)
McDonald's (US large cap predictable)
Clorox (US large cap predictable)

Portfolio C: Aggressive

Includes: Large cap predictables and large cap growths

Portfolio C is for the more aggressive investors who like the challenge of studying individual companies and picking winning stocks that will beat the market. This investor is willing to invest the time to monitor his stocks and to sell for profits when the time is right. An example is presented below:

Portfolio C
Apple (US large cap growth)
Google (US large cap growth)
MasterCard (US large cap growth)
Nike (US large cap predictable)
Procter & Gamble (US large cap predictable)
Asia Pacific Breweries (Singapore large cap predictable)
VICOM (Singapore large cap predictable)
Jardine C&C (Singapore large cap growth)

Portfolio D: Very Aggressive

Includes: Large cap predictables, large cap growths, turnarounds/ deep cyclicals and small fast growers

This investor wants to maximize his potential returns and is willing to spend considerable time to study his stocks regularly to minimize risks. This investor is willing to take losses in some stocks in order to generate even larger returns in others. Again, an example is presented below:

Portfolio D
Yahoo! (turnaround)
Caterpillar (US deep cyclical)
Diana Shipping (US deep cyclical)
OSIM International (Singapore small fast growers)
Goodpack (Singapore small fast growers)
Visa (US large cap growth)
Bank of America (US deep cyclical/turnaround)
Noble Group (Singapore deep cyclical)

6) Adapt Your Portfolio to the Market Cycle

You have learned in a previous chapter that the stock market goes through cycles of highs and lows, leading the economic boom and bust cycle by 6 – 9 months.

When the stock market is recovering from the bottom of the cycle, there is usually still a lot of fear and uncertainty in the market. This is when cyclical stocks like banking, real estate, industrial and consumer discretionary stocks will be much undervalued. At the same time, defensive stocks will tend to become very expensive during this period of time. This is because most people would be putting their money into safer havens.

This would be a good time to shift your portfolio away from defensive stocks into more of these cyclical stocks, buying them at cheap levels. However, always ensure that these stocks have reversed to an uptrend. Buying them while they are still on a downtrend may lead you to further losses before your investments start to reap gains.

When the stock market is at its high, cyclical stocks will begin to get very expensive and defensive stocks will start to look cheap again. During this period, investors would have dumped the boring defensives for the more exciting cyclicals, pushing the former lower and the latter higher. This is the time to start taking profits on your cyclical stocks and buying into the cheap defensive stocks again. Remember that the key to beating the market is to buy low (when the majority is not interested) and selling high (when the majority is fully invested).

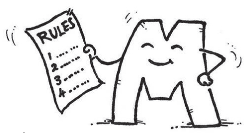
Do you have a much better idea of the kind of stocks to invest in now? Great! I look forward to seeing you in the next chapter.

NINE
CHAPTER

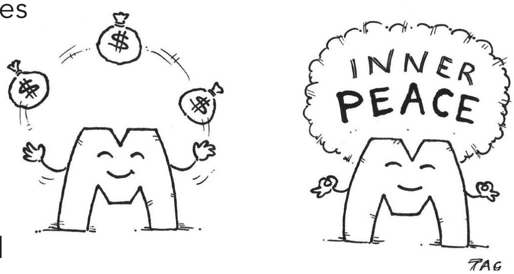
Method, Money & Mind: The Three Keys to Success

Method, Money & Mind: The Three Keys to Success

CHAPTER**NINE**



In this chapter, I will help you put everything you have learned together so that you understand how to really succeed in the markets. What does it take to become a highly profitable investor? Well, all successful investors are able to master the three M's: *Method, Money* and *Mind*. I first learned about the three M's by studying the work of Dr. Alexander Elder, a psychiatry-trained professional trader who specializes in trading psychology. Let me explain what they mean in detail.



1) *Method* — Winning Strategy

To profit consistently, you have to follow a method (or strategy) that gives you an edge for picking winning stocks that are beyond random chance. This means following a set of predefined buy and sell rules that you have learned in Chapter 3, 5 and 6.

Unfortunately, many untrained investors make their buy and sell decisions very randomly. Sometimes, they buy because of a hot tip from a friend and sometimes they sell because they "feel" that the stock has gone too high. As a result of not using a consistent method, they fail to get consistent results. Their chance of being right is at best 50/50. They are merely gambling their money away.

Winning investors never invest randomly. They have the discipline to follow strict buy and sell rules that give them a high probability of being right. These rules tell them WHAT to buy, WHEN to buy and WHEN to sell. These are all the rules that you have learned throughout the book. Let's do a recap:

WHAT to Buy

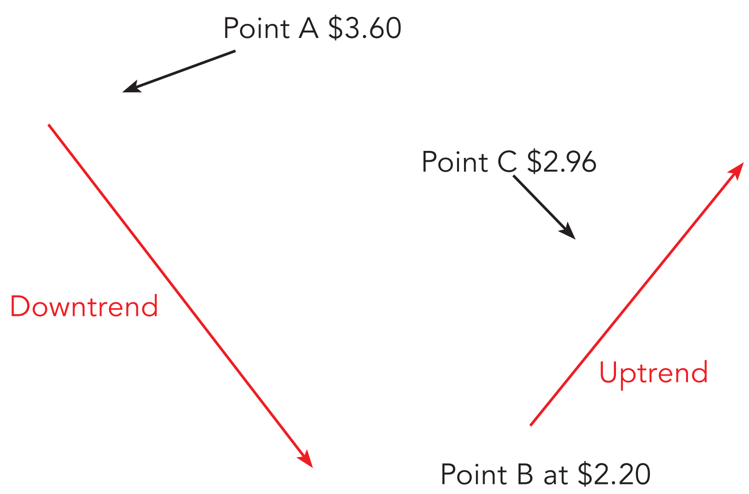
Buy only fundamentally strong companies that have consistently increasing sales revenue, net income and cash flow. These great companies should have high future growth, return-on-equity and conservative debt. Ensure that you invest in companies that pass these fundamental criteria covered in Chapter 5 and 6.

WHEN to Buy

Knowing WHAT to buy is not as important as knowing WHEN to buy it. Untrained investors make the mistake of investing in a good company at the wrong time (i.e. during a downtrend). As a result, they see the value of their stocks going lower and lower and get their money stuck for years before seeing any returns. This is why we should only buy a stock when it is on an uptrend. On an uptrend, there is a higher probability that the price will move upward, thus generating profits for you. We determine an uptrend by ensuring that the 50 DMA has crossed above the 150 DMA and the two moving averages are sloping upward! Alternatively, the daily candles should be above the 200 DMA and the 200 DMA must be sloping upward.

The example below shows the result of buying a great company at the wrong time. CapitaLand is a fundamentally strong company. However, if you had bought it on a downtrend at Point A ($3.60), you would have seen your investment fall by 39% to Point B ($2.20). Knowing WHEN to buy at Point C ($2.96) during an uptrend would have resulted in a 28.3% gain in a few months.

Chart 9.1: CapitaLand 2010 – 2012



Credit: www.chartnexus.com

WHEN to Sell

The most important part of your investing method should be following the rules of WHEN to sell. This rule ensures that you minimize your losses when you are wrong and maximize your profits when you are right.

Winning investors strictly follow their sell rules without compromise. They understand that if they do not sell at the right time, mistakes can turn into huge losses and potential winning investments can turn into losing ones.

Two investors who buy the same stock at the same time can get very different results depending on WHEN they sell. In the example below, two investors bought Monster Beverage (MNST) at the same time (Point A, $18).

Investor A sold at $20.90, when the stock fell 5% below its $22 high point. Investor A scored a 16.1% profit.

Investor B sold at $14.60, only when the 50 DMA crossed below the 150 DMA. Investor B made an 18.8% loss.

Chart 9.2: Monster Beverage (MNST) Chart 2012

Credit: www.thinkorswim.com, ProphetCharts®

Recall from Chapter 6 (under 'Knowing When to Sell') that you should hit the sell button when…

- The stock price falls 5% – 8% below your purchase price (cut your losses)
- The stock price reverses to a downtrend (50 DMA crosses below 150 DMA, or price crosses below 200 DMA, with moving averages sloping downward)

- The stock price falls 5% – 8% below a recent high (protect your profits)
- Follow one of the three rules that comes first

If you consistently follow the 3W rules: WHAT to buy, WHEN to buy and WHEN to sell, you will be able to achieve a high probability of success.

2) *Money* — Risk and Money Management

The second 'M' that you have to master is *money* management. This involves managing your risks such that you never suffer huge financial losses in the event of a losing investment. There are many investors who use a superior *method* but still end up losing money because they failed to master *money* management principles.

Risk and money management is essential because no method can guarantee us a winning outcome every time. No matter how carefully we analyze a company or follow a price trend, the price can suddenly reverse downward because of news events that are impossible to predict. If you risk too much of your money on an investment that goes bad, a single loss can wipe out ten profitable prior investments. Even if you have a winning percentage of 90%, you can still end up losing money if the losses from the 10% of bad investments outweigh the profits from the 90% of winning investments.

In reality, the best investors/traders in the world achieve a percentage win rate of 55% – 70%. In fact, I know many traders who are right only 52% of the time. However, they still end up very rich because the profits they make 52% of the time are far more than the losses incurred when they are wrong 48% of the time.

Golden Rules for Money Management:
1) Risk a fixed percentage of your capital for any single trade/investment
2) Risk a maximum of 1.5% – 3% of your capital on any single trade/investment

The key to effective money management is to consistently risk a fixed percentage of your capital on any single trade/investment. This fixed percentage should be a maximum of 1.5% – 3% of your capital.

For example, if your capital (i.e. account size) is \$20,000, you can afford to risk 1.5% × \$20,000 = \$300 on any single investment. If you want to invest in a stock like Bank of America (BAC), does it mean you can only buy \$300 worth of shares? No.

Your risk (the amount you can lose) per investment is determined by where you place your stop-loss. Recall that whenever you make any investment, you always place a stop-loss 5% – 8% below your purchase price. If you buy BAC at \$10, you could place your stop-loss at \$9.20.

The worst that can happen is that BAC declines in price and hits the stop-loss price of \$9.20. So, your maximum risk per share is \$10 - \$9.20 = \$0.80. Since your maximum risk per investment is \$300, how many shares of BAC can you afford to buy? The answer is \$300 ÷ \$0.80 = 375 shares.

In other words, your capital is \$20,000
You can afford to invest in 375 shares of BAC at \$10 (stop-loss \$9.20)
Your position in BAC is \$10 × 375 = \$3,750
Your maximum risk = \$0.80 loss per share × 375 shares = \$300

Position Sizing Formula

Given that our risk per trade is always fixed as a percentage of our capital, the number of shares we can afford to buy would be determined by where we place our stop-loss.

In any investment, first determine your entry price and your stop-loss price. You can then determine your position size using this formula:

$$\text{Number of shares} = \frac{\%\ \text{Risk per trade} \times \text{Capital}}{\$\ \text{Risk per share}}$$

Let's see how you can use this formula in another example. Assume that you want to make a second investment in Google (GOOG) at $700. You decide to place your stop-loss at $644 (8% below the purchase price). How many GOOG shares can you afford to buy?

Capital = $20,000
% Risk per trade = 1.5%
$ Risk per share = $700 - $644 = $56

$$\text{Number of shares} = \frac{1.5\% \times \$20{,}000}{\$56} = 5 \text{ shares (rounded off)}$$

GOOG investment = $700 × 5 = $3,500

How Many Investments Can I Have at a Time?

Given a capital of $20,000 and a risk per investment of 1.5%, each investment will make up a position size of approximately $3,500 – $3,800. This means that you will be able to invest in a maximum of 5 different stocks concurrently. In doing so, the total risk to your portfolio would be 7.5%.

	Stock	Position	Risk (1R)
1	BAC	$3,750	1.5%
2	GOOG	$3,500	1.5%
3	Stock C	$3,800	1.5%
4	Stock D	$3,800	1.5%
5	Stock E	$3,800	1.5%
Total		**$18,650**	**7.5%**

If you decide to risk the maximum of 3% of your capital on each investment, then each position size would be approximately $7,600 and you would only be able to take on 3 investments concurrently.

If were to use a leveraged margin account or CFDs, you would of course be able to take on larger and more positions. However, my suggestion is to never expose your portfolio to a total risk of more than 10% at any one time, even if you use leverage.

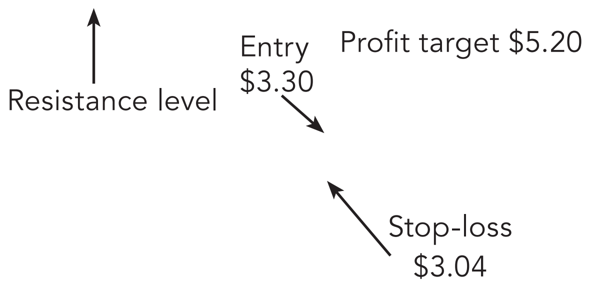
What Returns Should You Aim For?

In order for your strategy to be profitable, you should only take on an investment if the potential profit per share is at least double your potential risk per share. In other words, the profit target distance should be at least double the stop-loss distance. This will give you a risk-to-return ratio of 1:2. Anything less would not be worthwhile.

You can determine your profit target based on the intrinsic value of the share or the next level of price resistance (whichever is nearer). In the example below, I made an entry into Nokia (NOK) at $3.30 when the 50 DMA crossed above the 150 DMA (and the 150 DMA stopped sloping downward).

I placed a stop-loss at $3.04 ($0.26 below purchase price). The profit target was $5.20 since that was where the next resistance level was.

Chart 9.3: Nokia (NOK) Chart 2012



Credit: www.thinkorswim.com, ProphetCharts®

Since my risk per share was $0.26 and potential profit per share was $1.90, my risk-to-return ratio worked out to be 1:7.3, way above the 1:2 threshold. This made it a worthwhile investment.

A very important concept to understand is the **'R-Multiple'** concept. 'R' refers to our risk per investment. Since we always risk a fixed 1.5% – 3% of our capital, our R is always fixed.

Whenever we take on a new investment, we are risking 1R of our capital. We always aim to achieve a profit of at least 2R. In the case of Nokia (NOK), the potential return is 7R.

As an investor/trader, our goal should be to achieve as many R's as possible for a number of investments. When our investment is a losing one, we are down -1R. When our investment is a winning one, we may not always hit our profit target and achieve 2R. Sometimes, we may end up with actual profits of 0.5R, 1R, 1.5R and at times, we may get profits of 2.5R, 3R or more. If NOK hits the profit target, we accumulate 7R!

Determine the Expectancy of Your Strategy

By consistently following the rules of a winning method and money management strategy, you will definitely achieve a positive expectancy per trade/investment. **'Expectancy'** refers to how much you can statistically expect to achieve by following the rules over time.

This is the formula:

**Expectancy per investment
= (% Win × Average win) - (% Loss × Average loss)**

As mentioned earlier, no method can guarantee you success 100% of the time. In reality, the best investors/traders in the world achieve a percentage win rate of 55% – 70%. To be conservative, let's assume you maintain a winning percentage rate of 60% and a losing percentage of 40%. So…

Expectancy = (% Win × Average win) - (% Loss × Average loss)
= (60% × Average win) - (40% × Average Loss)

Recall that your average loss is 1R and that you aim for an average win of 2R. However, let's conservatively assume that you achieve an average win of 1.3R.

Thus, your expectancy per investment
= (0.60 × 1.3R) - (0.40 × 1R) = 0.38R

This means that on average, you will achieve an expected profit of 0.38R for every investment you make. So, for every 10 investments you make, you should make a profit of 3.8R. For every 20 investments you make, you should make a profit of 7.6R and so on…

Since 1R represents a 1.5% risk of your capital, then…
A 3.8R gain represents a 5.7% return on your capital
A 7.6R gain represents a 11.4% return on your capital
A 15R gain represents a 22.5% return on your capital, and so on.

What Returns Do You Aim to Achieve a Year?

Once you know your expectancy per investment, you can then calculate the number of investments required to achieve your desired return.

For example, assume the following:

- You have a capital of $100,000 to invest
- You decide to risk 1.5% of your capital per investment, thus 1R = 1.5%.

If your goal is to achieve a 30% annual return, which is $30,000 in profits, how many investments must you make a year?

If your expectancy per trade = 0.38R = 0.38 × 1.5% = 0.57%, to achieve a 30% return,
the number of trades required is $\frac{30\%}{0.57\%}$ = 52 trades a year
= 4 trades per month

Professional investors make more than 20 trades in a month. At an expectancy of 0.38R per trade, that equates to 0.38R × 20 = 7.6R per month. 7.6R a month translates to 7.6 × 1.5% = 11.4% return per month.

11.4% return per month compounds into a whopping 327% annual return. This is what top professional investors in the world are able to achieve. Take a look at the table below and see how $20,000 compounds at 11.4% per month for 12 months.

Table 9.4: Starting Capital $20,000 Compounding at 11.4% per Month

January	$20,000	July	$38,224
February	$22,280	August	$42,582
March	$24,820	September	$47,436
April	$27,649	October	$52,844
May	$30,801	November	$58,868
June	$34,313	December	$65,579

Increasing Your Risk per Investment Increases Potential Return, but Volatility As Well

At this junction, you may be wondering what would be the result of increasing your risk per trade to the maximum of 3% of capital. Would this increase your potential returns? The answer is 'yes'.

By risking 3% of your capital per trade, your 1R = 3%. So, 5R = 15% return and 10R = 30%. However, the flip side is that you would make bigger losses on losing trades. A losing trade would cause your portfolio to fall 3%. Five losing trades in a row would cause a drop of 15% in your capital.

If you consistently follow a winning *method* and *money* management, then over time, the bigger profits from winning trades would outweigh the bigger losses from losing trades. This would result in a higher expectancy per trade. However, in the short term, you must be prepared for larger drawdowns in your capital when the losing trades come.

3) *Mind* — Managing Emotions

As you can see, by following a winning *method* and *money* management rules, you can grow your capital by 200% – 300% a year. You can achieve financial freedom like many other successful professional investors.

If it is this simple, then why doesn't everyone quit their job, pull all their money from their savings account and start trading to get rich? The reason is that although the strategy to get rich investing is simple, it is <u>not easy</u>! Although you may know all my investing rules, you may still not be able to achieve the same results that I can. This is because the final 'M' that makes all the difference is the *mind*.

You must have a strong mind to manage your emotions when it comes to investing. Money is a very emotional issue for many people and more often than not, the emotions of investing your money tend to make you counterproductive. This is why I focus so much on training my students at *Wealth Academy™* to develop the winning mindset of top investors. Without this winning mindset, you will still not be able to achieve consistent profits even if you know the most effective strategies.

Why Is Mindset So Essential?

Like I said, although the *method* and *money* rules are simple to understand, they are <u>not easy</u> to follow in reality. This is because you need tremendous discipline to work hard and follow the rules. If you do not have the mental discipline, emotions like laziness, pride, fear and greed will cause you to deviate from the rules and end up with losses instead.

A great analogy I can give you is that of losing weight. Only 10% of people who enroll for a weight loss program actually lose weight. This is because the majority of people do not have the emotional discipline to stick to the prescribed diet and required hours of exercise.

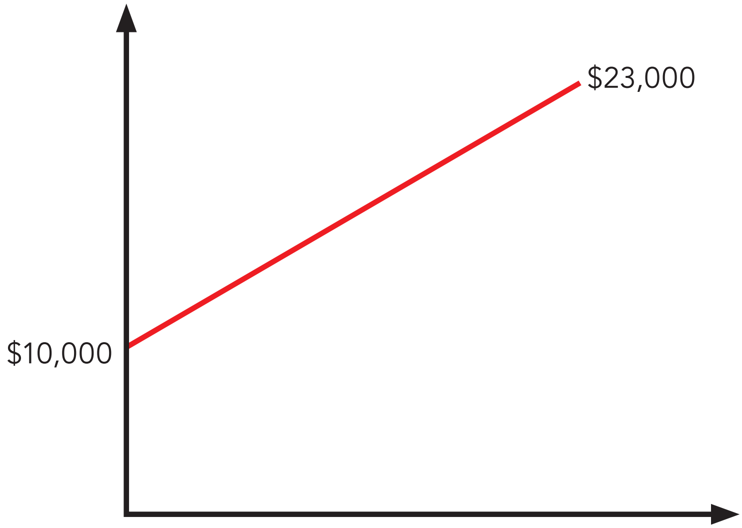
Successful investing is not that much different from successful dieting. This is why less than 10% of wannabe investors actually get rich, even after they have learned the right fundamental and technical strategies. The reason why so many of the students I mentor get rich is because I emphasize more on the mindset and the managing of emotions than on merely the technical strategies.

Having the Emotional Discipline to Manage Drawdowns

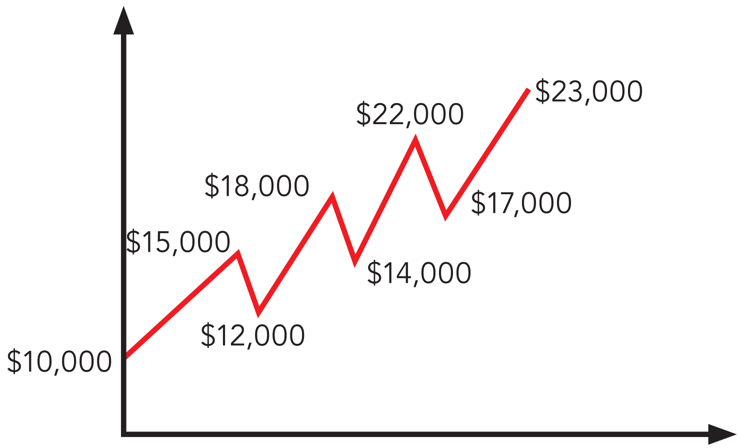
One of the reasons many investors fail to follow the rules and succeed is because they get emotionally affected by losing investments and subsequent drawdowns in capital. A **drawdown** is a reduction in your capital as a result of a losing trade or a series of losing trades.

In the world of investing, stock prices do not go up in a straight line. Consequently, your capital (and wealth) does not go up linearly as well. It goes through a series of ups and downs (cycles) in order to move higher.

Your Capital Will NOT Increase Linearly....



Your Capital Will Increase with a Series of Drawdowns....



In real-world investing, wins and losses do not come evenly distributed. Sometimes, you have many wins in a row and losses in a row (up to 4 – 5 at times). Even if you use an effective strategy and expect to achieve a win rate of 70% (and loss rate of 30%), this ratio does not always play out over a few trades. This probability only plays out over a larger sample size of many trades (>50).

For example, tossing a coin will give you a 50% probability of getting heads. However, if you toss a coin 10 times, you do not always get 5 heads and 5 tails. You may in fact get 3 heads (and 7 tails) or 7 heads (and 3 tails). There is of course nothing wrong with your coin. It's just that a small number of tosses is statistically insignificant. Toss the same coin 50 or more times and you will see the heads and tails start to balance.

Similarly, you will only experience the success of an investing strategy if you keep investing consistently over the long term. You cannot expect every ten trades to yield a 60% – 70% win ratio. Some ten trades may yield a 40% win ratio and the next ten may yield an 80% win ratio.

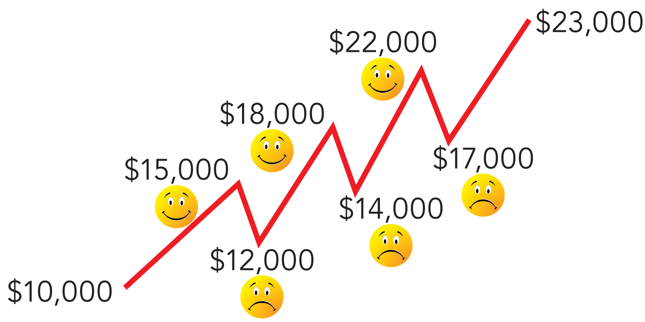
Greed, Fear and the Recency Bias of Investors

The trouble is that many people are affected by the recency bias and get overconfident after a few winning trades and fearful after a series of losing trades. These emotions cause them to deviate from the rules and fail in achieving their profit goals.

For example, after a series of wins, your capital grows from $10,000 to $15,000. You feel confident in your investing strategy and start to get greedy. You decide to increase the risk per trade and potential returns. Sure enough, when the losses come, you end up losing more!

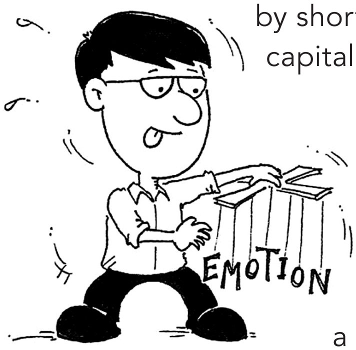
As you experience a series of losses and feel the pain of your capital sliding from $15,000 to $12,000, you get confused, angry and fearful. You will start to doubt your strategy and reduce your risk per trade (and potential profits). Then, when the wins come, you end up making less profits.

By adjusting your risk per trade based on how you feel, the net result is that over time, you are going to lose more and profit less. When you start to see your capital stagnating or declining, you will start to lose interest and abandon your investing plans. Some people will even hop from strategy to strategy, adding in more and more rules and technical indicators, hoping to search for the "ideal strategy" that will increase their winnings. Of course, it will never come.



Again, this is similar to a person who goes to the gym five days in a row, and expects to see a significant weight loss. When he/she doesn't get the instant results, they start to lose motivation and abandon their exercise plans.

So, the key to becoming successful is to do your best to be emotionally detached from your investing decisions. Do not let the outcome of a few trades make you feel greedy or fearful. A few trades are statistically insignificant. The secret is to think statistically over the long term and not get emotionally affected by short-term swings and drawdowns in your capital.



A way that I shield myself from the psychological effect from losing or making money in my investment is to think of my wins and losses in terms of R-multiples. So, when I make a profitable investment, I never tell myself that I made $8,000 or 5% return. Instead, I tell myself that I made a '3R' win. Similarly, when losses come, I see them as a '2R' drawdown. This helps me to think more objectively and results in more consistent profits over time.

Take a look at the capital (equity) curve of a successful investor as well as his trade records. You can see that in growing his capital from $50,000 to $140,000, he had to go through periods of drawdowns, some as much as -7% to -8%.

Figure 9.5: Sample Equity Curve of a Successful Investor

On trade-by-trade basis, you can see the result of his first 25 investments. The first 25 investments brought his capital from $50,000 to $60,000. However, there were times when he had to go through 3 losses in a row (Trade 4,5 and 6). However, over time, the wins will outweigh the losses if he sticks consistently to his money management strategy.

Figure 9.6: Sample Trade Results of a Successful Investor

Pride — The Emotional Downfall of Most Investors

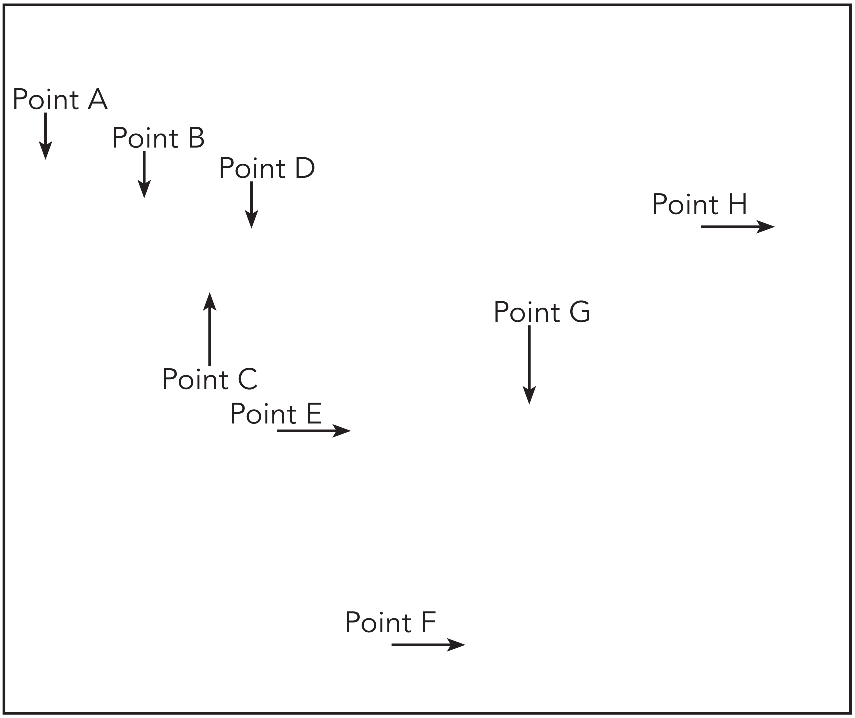
Besides the emotions of fear and greed, pride is the most common emotion that leads to the downfall of many investors and traders. Pride can be a good thing at times, but it has no place in the stock market.

Most people with big egos and pride often fail as investors because of their psychological need to be right all the time. They are also not willing to admit defeat easily. This pride will cause them to hang on to losing investments and not cut their losses. As a result, their big losses from bad investments will wipe out their profits from their winning investments.

Like I mentioned earlier, the secret to successful investing is not to be right all the time. It is to make more money when you are right and lose less money when you are wrong. The only way to achieve this is to cut your losses quickly and let your profits run!

Let me show you a typical example of an investor who lets pride get in the way of following the rules of successful investing and money management.

Chart 9.7: American Express (AXP) Chart 2007 – 2010



Credit: www.thinkorswim.com, ProphetCharts®

Point A: The investor buys the stock AXP at $57.50 after confirming that it is a good company on an uptrend (50 DMA above 150 DMA)

Point B: The stock reverses to a downtrend because of the US financial crisis. The 50 DMA crosses below the 150 DMA and the price is now $52.50 (down 9%)

Instead of following the rule of selling during a downtrend, the investor feels angry and thinks,
"How can it be? It is a good company! How can it go down?"
"If I sell now, I will realize the loss of $5 per share. If I hold on for a while, I am sure it will bounce back."

Point C: The stock falls to $37.50 (down 35%)
The investor gets more angry and thinks,
"It is a good company. I know it will come back. It is a long-term investment." (famous last words)

Point D: Stock rises to $47.50
Investor starts to see a glimmer of hope.
"Ha! Luckily I did not sell. It is recovering! Maybe I should buy more at this cheaper price!"

Point E: Stock falls to $22
Investor is in denial.
"It has gone so low, there is no point in selling now. It can't go any lower." (famous last words)

Point F: Stock falls to $10
Investor in despair says,
"I don't' even want to look at it."

As you can see, this is how the emotions of 'pride', 'anger', 'hope', 'denial' and 'despair' cause a small loss to balloon into a huge loss.

Investors who have mastered their *mind* do not let emotions affect their decisions. They follow their buy and sell rules objectively. A successful investor who bought AXP at $57.50 would have sold at $52.50, the moment a downtrend was confirmed. He would have just accepted the loss of $5 as part of the investing game of wins and losses.

The successful investor would only have re-entered the stock when the new uptrend was confirmed at Point G, buying at $22.50. As a result, he would have made a $25 profit when the stock rose to $47.50 (Point H).

So, there you have it! The three M's of successful investing — *Method, Money* and *Mind*. Master these keys to success and you will soon reap the huge rewards of this exciting journey of investing. Now, let's move on to the final chapter on how to turbocharge your returns with advanced investing techniques!

TEN
CHAPTER

Turbocharging Returns by Leveraging and Shorting

Turbocharging Returns by Leveraging and Shorting

CHAPTER**TEN**

Up till this point, you have learned how professional investors select stocks of great companies, time the market with charts and manage their money. In this chapter, I am going to elevate your investing skills to a whole new level.

I am going to show you the tools that sophisticated hedge fund managers use to achieve explosive returns from the market. With these tools, you will be able to achieve returns 5 – 10 times more than a normal investor and be able to profit even during market downturns.

The sophisticated techniques that I use are not meant for everyone. They are only meant for people who are willing to work hard to master the skills and have the emotional discipline to follow the rules.

While these techniques can increase your profits rapidly, they can also cause you to lose everything fast, if not used carefully. While traditional successful investing techniques are akin to driving a Mercedes Benz, the sophisticated techniques I am going to show you are like driving a Formula One car at 300km per hour. You can reach your financial goals at super speed but if you are not skillful enough to handle the speed and follow the safety rules, you can crash and burn! If you are excited and ready, let's get started!

The Power of Financial Leverage

Have you ever read about hedge fund managers who are able to achieve 100% – 1,000% return from a single trade/investment or professional traders who can turn $10,000 into $100,000 within a few days? While it is certainly not easy, it is indeed possible by using the power of financial leverage.

Financial leverage is the process of multiplying your gains (and potential losses) by using "other people's money". Many people may not realize this, but they use financial leverage whenever they buy a piece of property.

For example, if you buy a small apartment in Singapore for $1 million, you don't have to fork out $1 million in cash. To afford the purchase, you usually put a down payment of 20% (i.e. $200,000) and take a loan from the bank for the remaining 80% (i.e. $800,000). You are leveraging on the bank's money to make the $1m investment.

In return, you have to pay interest (currently 1.5% per annum) on the borrowed sum. Let's assume that you rent the apartment for $3,500 a month, which is more than enough to cover the interest.

Let's then assume that in five years, the apartment's price increases by 25% to $1.25 million. By selling the property, you would make a tidy profit of $250,000. However, your rate of return is not 25%, it is a lot more than that!

Since you only invested $200,000, your $250,000 profit would be equal to a 125% (($250,000 ÷ $200,000) %) rate of return. Putting down 20% and borrowing 80% has allowed you to leverage your returns by 5 times (×). The 25% price increase has been multiplied to a 125% return on investment (5×).

Leveraging in the Stock Market

Many people are very used to using financial leverage in the property market but few people realize that the same thing can be achieved in the stock market. In the stock market, you can even leverage your investment up to 10 times (×). You can make a down payment of $10,000 (10%) to buy $100,000 worth of stocks. You do this by "borrowing" $90,000 (90%) from the broker. Let's look at the ways this can be done.

Leveraging with Margin Trading

The most common way to leverage up is to open a margin trading account (MTA) with any local broker. This will allow you to use cash or shares as collateral in order to buy more shares on credit (loan).

Typically, margin accounts allow you to leverage up to a maximum of 3.5 times. If you deposit $10,000 of cash to the broker, you will be able to buy up to $35,000 worth of shares (3.5×). The broker will usually charge you an interest rate of 4% – 5% per annum on the amount borrowed.

Imagine if you bought $35,000 worth of CapitaLand shares ($3.50 per share × 10,000 shares) using $10,000 worth of margin. If CapitaLand shares increased by 10% to $3.85, you would make a profit of $0.35 × 10,000 = $3,500.

Since your cash investment was only $10,000, your rate of return would be ($3,500 ÷ $10,000) % = 35%. The 10% increase in stock price has been multiplied by 3.5 times. Of course you still have to deduct the cost of borrowing and commission, which is a small price to pay for the leverage.

However, if the stock price drops by 10%, your loss will be magnified by 3.5 times as well. If CapitaLand falls by 10% to \$3.15, you would make a loss of \$0.35 × 10,000 = -\$3,500. This would equate to a 35% loss. So, leverage works both ways.

To ensure your profits far exceed your losses (when your investment goes wrong), you have to practice prudent money management strategies like cutting loss, risking a small percentage of your capital and position sizing. All this will be discussed later. You also have to learn how to pick stocks with minimal downside and very high potential upside.

Leveraging with Contracts for Difference (CFDs)

Besides using a normal margin account to buy shares on margin, I also use an instrument known as **'contract for difference'** (CFD). CFDs allow me to leverage up to 10 times if I want, while paying a much lower rate of interest. At the same time, CFDs allow me the flexibility to short sell ('short') Asian stocks that are on a downtrend.

Let me explain what CFDs are. When you buy a share of stock from the market, you are buying a piece of a company from another investor. When you buy a stock CFD, you are not buying the company's shares directly. You are buying an agreement between yourself and a CFD broker.

This is an agreement to exchange at the close of a contract, the difference between the opening price and the closing price of the underlying stock. CFDs are known as derivatives because they derive their value from an underlying asset (i.e. the share of a company). The CFD price mirrors the price of the underlying stock. So, if Google's stock price is \$700, Google's CFD price will also be trading at \$700. Instead of buying the actual Google share, you could buy the Google CFD.

If you buy 100 Google CFDs at a price of $700 and the price goes to $800, the CFD broker will pay you the difference of $100 in profit if you sell to close the contract at $800.

If you short sell 100 Google CFDs at a price of $700 and the price goes to $600, the CFD broker will pay you the difference of $100 in profit if you buy to close the contract at $600.

Advantage of CFDs

You may be wondering why you would buy CFDs when you can buy the actual company's shares directly. Well, buying CFDs has some powerful advantages:

1) CFDs Allow You the Highest Leverage

CFDs allow you to take positions on the underlying shares with margins as low as 5% – 10%. For example, if you want to buy $10,000 worth of Google shares, you only have to put up a margin of 10% ($1,000). This "down payment" of $1,000 will allow you to control $10,000 worth of shares. This gives you a leverage of 10×.

Margin	Leverage
5%	20 times
10%	10 times
20%	5 times
50%	2 times

Some CFD brokers like CMC Markets (www.cmcmarkets.com.sg) allow you to adjust your margin from 10% to 100%. This means that you can choose to put up just 10% of the invested amount in cash or increase it to 15%, 20% and so on. If you choose a 50% margin, then you are getting 2× leverage.

CFDs also allow you to buy indexes and index ETFs (e.g. S&P

500, Straits Times Index, Hang Seng Index, Dow Jones) on margin, In fact, for indexes, you only have to put up a margin of 5%. When you buy US shares on margin, you have to pay an interest (FED rate* + 2% per year) which adds up to 2.15% (at the time of my writing). Interest is charged and deducted daily from your account.

** FED rate is the overnight interest rate set by the US Federal Reserve*

2) CFDs Enable You to Buy Odd Lot Shares

The problem with buying shares in Asian countries like Singapore, Hong Kong and Malaysia is that you have to buy minimum round lots of 1,000 or 100 shares.

This makes some expensive shares difficult to afford for small investors. For example, 1 share of UOB costs $20. A minimum investment of 1,000 shares for this Singapore counter would cost $20,000.

CFDs allow you to buy less than 1,000 shares of any counter. You can use CFDs to buy just 100 shares of UOB at a total cost of $2,000. If you choose to use a 10% margin, your cash investment becomes just $200.

3) Long Positions on CFDs Pay Dividends

Although you may only put up a margin of 10% to buy CFD shares of a company, you receive dividends on the total investment position. This is provided the company pays a dividend during the specified period.

For example, if you buy 1,000 CFDs of UOB at $20, your total position would be $20,000. You put up a margin of 10% ($2,000). If UOB pays a dividend of $0.50 per share, you will receive the full dividends of $0.50 × 1,000 = $500.

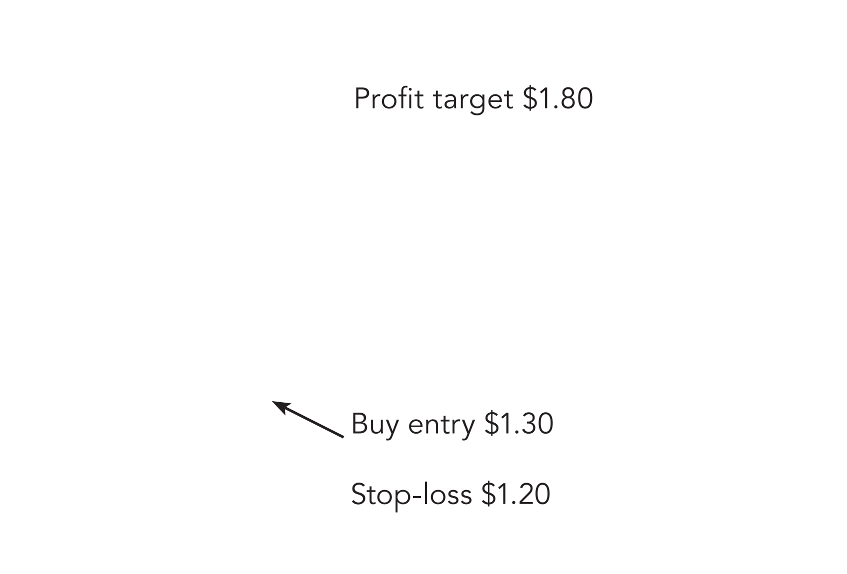
4) CFDs Allow You to Short Sell Shares

Many Asian stock markets like Singapore and Malaysia prevent you from short selling shares. Well, with CFDs you can get around this regulation. CFDs allow you to short Asian shares and even Asian indexes. This allows you to profit from the decline on the Straits Times Index and Hang Seng Index during periods of downturns. More on this later!

Case Study: Going Long with CFDs

Let me give you an example of how I have used CFDs to leverage my returns. On 27 August 2012, I decided to go long on OSIM International (listed on Singapore Exchange) at a price of $1.30 when moving averages signaled an uptrend.

Chart 10.1: OSIM Chart 2012



Credit: www.chartnexus.com

After doing an intrinsic value calculation, I found that OSIM had the potential to rise to $2.50 (92% upside) but there was a strong resistance line at $1.80 (38% upside). To be conservative, I set $1.80 as my first profit target. I also set a stop-loss price of $1.20.

I decided to buy 20,000 OSIM CFDs at $1.30

My long position = $1.30 × 20,000 = $26,000

Since CFDs allow me to put up a margin of 10%, my cash investment was 10% × $26,000 = $2,600

My financing (interest charge) was 2.3% per annum at the time. So, the interest charged per day was (2.3% × $26,000) ÷ 365 = $1.64 per day

I had to pay broker's commission of 0.15% of my contract value. So, my buying commission was 0.15% × $26,000 = $39

In 4 months (114 days later), OSIM rose and hit a resistance at $1.80. When the price fell 5% below this high, I sold the CFDs to take profits at $1.71. The stock had risen 31.5% from its entry price.

I sold my OSIM CFDs for proceeds of $1.71 × 20,000 = $34,200

I had to pay my broker a sales commission of 0.15% × $34,200 = $51.30

For holding my position for 114 days, I was charged a total interest of $1.63 × 114 days = $185.82

My net profit worked out to be $34,200 - $26,000 - $39 - $51.30 - $185.82 = $7,923.88

Since I only invested $2,600 in cash,
my rate of return was $\frac{\$7,923.88}{\$2,600} \times 100\% = +305\%$

By using the power of leverage, my returns have been magnified almost 10 times!

What if OSIM Had Declined Instead?

Of course, there is a real possibility that the stock could have declined in price instead. Remember that the stock market is a volatile place that is ruled by emotions in the short term. It is very possible that a fundamentally good, undervalued stock on an uptrend can suddenly reverse to a downtrend. Only in fairytale land will stock prices always move in your desired direction.

This is why we always place a stop-loss 6% – 8% below our purchase price. Especially in the case of leveraged trading, we have to always minimize our losses in the event of a bad call. Placing stop–losses allow us to control how much we lose if we are wrong.

Since my stop–loss for OSIM was $1.20, the broker would automatically sell my CFDs if the price fell to $1.20 or lower.

Assuming that OSIM declined to $1.20 in 20 days, the broker would close my contract and my CFDs would now be worth $1.20 × 20,000 = $24,000

I would sell the CFDs for $24,000 and pay a sales commission of 0.15% × $24,000 = $36. For holding the CFDs for 20 days, I would pay a financing charge of $1.63/day × 20 days = $32.60

My loss =

$24,000 -	$26,000 -	$39	- $36	-$32.60	
(Sales)	(Costs)	(Buy Comm)	(Sell comm)	(Interest)	= -$2,107.60

Since I invested $2,600 in cash,
My rate of return would be $\frac{-\$2,107.60}{\$2,600} \times 100\% = -81\%$

As you can see, leverage works both ways! When you make a loss, your losses are magnified by 10 times as well. While you sold the stock at an 8% loss, your actual loss was 81% (because of the interest).

Basically, I was willing to risk $2,107 to earn a profit of $7,923. This works out to be a risk-to-return ratio of 1: 3.8, or risking $1 to earn $3.80. In order to be a profitable trader, we should only take on trades that have a risk-to-return ratio of 1:2 or better!

You Do Not Have to Be Right All the Time to Make Huge Profits

When some people hear the possibility that they could lose 80% on their investment, they freak out! They do not want to run the risk of losing any money at all. They just want to make money all the time.

Unfortunately, in the world of investing, a 100% win rate is impossible. Remember that to become rich, you must move away from the mindset of 100% guarantees. That is how the financially unlearned think. That is why they can only hope to grow their money at 1 – 3% returns.

Successful investors do not expect every single investment to be profitable. They know that as long as they are right more often than they are wrong, and their average profits are larger than their average losses, they are guaranteed to see their capital grow over time. In fact, if your average profit is just 1.5 times more than your average loss, you only need to be right 50% of the time to be a profitable investor.

Principles of Successful CFD Trading

When you use CFDs or any other kind of leveraged instrument, you aim to take on short-term trades (less than 3 months) and not longer term investments. With the leverage effect, you can already achieve high double-digit returns over a very short-term period.

The key to being a profitable trader is to ensure that your have a positive statistical expectancy per trade. In the previous chapter, you learned that the formula goes this way:

Expectancy per trade
= (% Win × Average win) – (% Loss × Average loss)

In other words, you only need to be right (% win) more often than you are wrong (% loss) and your average win needs to be greater than your average loss.

To achieve this, we need to follow these important principles:

1) Only take on high probability trades so that you have a win rate above 50%. If you follow the buy rules in previous chapters, you should achieve a win rate of 55% – 70%

2) Take on trades that have a risk-to-return ratio of 1 : 2 or better. This ensures that your average profits exceed your average losses over the long run

3) Limit losses on losing trades by placing stop-losses

4) Always fix your risk per trade to a maximum of 1.5% – 3% of your capital

The most important thing about leveraged trading is to <u>preserve your capital</u>. Capital to an investor is like ammunition to a soldier. Once you run out of capital, the game is over! As long as you have capital and keep following a winning strategy, you will always make back any losses and a whole lot more!

You Can Achieve 5% – 10% Return a Month on Your Capital Trading CFDs. Here's How…

The leverage that you get from trading CFDs will enable you take on more positions with the capital you have. You will also be able to achieve higher returns in a much shorter period of time.

In fact, you can realistically achieve a return on investment of 5% – 10% per month on your capital. If you can do this consistently, a 5% return per month compounds your capital into a return of 179% per year!

Lets see how this can be done.

Assume that your risk per trade is fixed at 3% of your capital. Recall in the previous chapter that I used a risk per trade of 1.5%. When using CFDs, I increase my risk per trade to the maximum 3%.

This means that when I have a losing trade and the price hits my stop-loss, I will lose a maximum of 3% of my capital. This average loss per trade is represented by 'R'.

Recall also that I only take on a trade when the potential profit is 2R or more. However, not all winning trades will hit the profit target. Sometimes, I may get a profit of 0.5R and if I am lucky, I may even get a profit of 3R. To be conservative, I am going to assume an average win of 1.3R. I will also assume a very conservative win rate of 55%.

In this case, my expected profit per trade would be

= (% Win × Average win) - (% Loss × Average loss)
= (55% × 1.3R) - (45% × 1R) = 0.72R - 0.45R = 0.27

If I take on 10 trades a month, my average expected profit will be 0.27R × 10 = 2.7R

Since R = 3%, 2.7R would be equal to 8.1%. This means that conservatively, the average return per month on your capital is 8.1%. Let's take a look at how a capital of $10,000 compounds at 8.1% per month. As you can see from the table below, $10,000 grows to $23,555 in a year. That is a 135% annual return.

Jan	$10,000	Jul	$15,957
Feb	$10,810	Aug	$17,250
Mar	$11,686	Sep	$18,647
Apr	$12,632	Oct	$20,157
May	$13,655	Nov	$21,790
Jun	$14,761	Dec	$23,555

How Much Leverage Can I Afford?

The biggest mistake newbies make is to fully leverage their entire capital with CFDs. For example, if you have a capital of $50,000 in your CFD account, it seems very tempting to buy the maximum $500,000 worth of shares (10 times leverage). After all, taking on a position of $500,000 only requires you to up a margin of $50,000.

The untrained "gamblers" dream that if the stock they buy were to increase by just 10%, their profits would be 10% × $500,000 = $50,000. This doubles their capital from $50,000 to $100,000 overnight. This reckless use of leverage is the surest way to wipe out your capital overnight!

Imagine, if the price of your stock were to fall by just 5%, you would lose 5% × $500,000 = $25,000 (half your capital). If the price of the stock were to fall by 10%, your entire $50,000 capital would be gone. This is why CFDs can be extremely risky for amateurs who have no sense of risk and money management.

When trading CFDs, you still have to obey the golden rules of money management. Recall…

Golden Rules of Money Management:
1) Risk a fixed percentage of your capital for any single trade/investment
2) Risk a maximum of 1.5% – 3% of your capital on any single trade/investment

Use the Same Position Sizing Formula for CFDs

The number of CFD shares that we can buy for any single trade should still be governed by this position sizing formula:

$$\text{Number of shares} = \frac{\text{\% Risk per trade} \times \text{Capital}}{\text{\$ Risk per share}}$$

Again, we have to first determine where we put our stop-loss and our $ risk per share before calculating the size of our position (number of shares).

Case Study on Position Sizing

Let me now show you a real-life example of how to calculate the size and number of positions for a given CFD account size (i.e. capital).

CFD starting capital	$20,000
Risk per trade	3% of capital

You see a long opportunity to buy Caterpillar (CAT) at \$90. Your stop-loss is placed at \$84.60 and your profit target is \$105. How many CAT CFDs can you afford to buy?

Your \$ risk per share = \$90 - \$84.60 = \$5.40

$$\text{Number of shares} = \frac{3\% \times \$20{,}000}{\$5.40} = \frac{\$600}{\$5.40} = 111 \text{ shares}$$

Your position in CAT = 111 CFDs × \$90 = \$9,990
Your required margin = 10% × \$9,990 = \$990

With this first trade position in place, the risk to your capital is \$600 and the potential return is (\$105 - \$90) × 111 = \$1,665

How Many Positions Should You Take on Concurrently?

Every trade position you take on represents a 3% risk to your capital. So, how many positions should you take on concurrently?

Personally, I would not take on more than 5 of such trading positions. This is because 5 positions would represent a total risk of 3% × 5 = 15% to my capital. So, in the event that all 5 trades are losing ones, my capital will experience a drawdown of 15%!

Given that each trade has a profit potential of at least twice the risk, my total profit potential on 5 trades would be 5 × 6% = 30% return.

Capital $20,000
Risk per trade 3%

	Stock	Position	Risk (1R)	Return(>2R)
1	Long Caterpillar	$10,000	3%	6%
2	Long Citigroup	$10,000	3%	6%
3	Long Keppel Corp	$10,000	3%	6%
4	Short Best Buy	$10,000	3%	6%
5	Short Boeing	$10,000	3%	6%
Total		$50,000	15%	30%

Notice that by taking on 5 concurrent positions, your total position size would be approximately $50,000 (5 positions × $10,000 average position size) and the required margin would be just $5,000. You are leveraging your capital of $20,000 by 2.5 times!

Diversify by Choosing Positions That Are Not Correlated

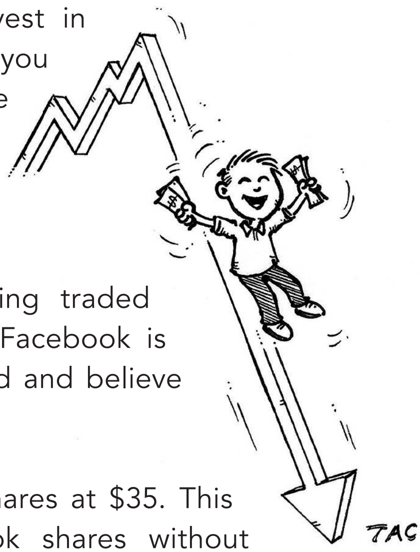
When building a portfolio of positions, it is important that you <u>do not take on positions that move closely together</u>. For example, if you were to go long on Citigroup, Bank of America, Goldman Sachs, UOB, and OCBC concurrently, it would be extremely risky.

All eight stocks happen to be banking stocks and stocks within the same sector/industry tend to be correlated (they move together). If a financial crisis hits and one stock goes down, it is highly likely that all of your 4 other stocks will go down together. You would end up with 5 losses in a row.

This is why you would want to invest in stocks that are as uncorrelated as possible. They could be stocks in different sectors and listed on different markets. In fact, you may even want to put in a few short positions to hedge against some of your long positions. This is the best way to diversify and increase your odds of coming up profitable. Let me now explain what shorting a stock is all about.

Shorting: Profiting on the Declines of Stocks and Indexes

Most people are aware of and comfortable with the idea of profiting when stocks they invest in appreciate in price. However, you can profit just as easily when the price of a stock or index falls. This process is known as **'short selling'** or simply, 'shorting'.

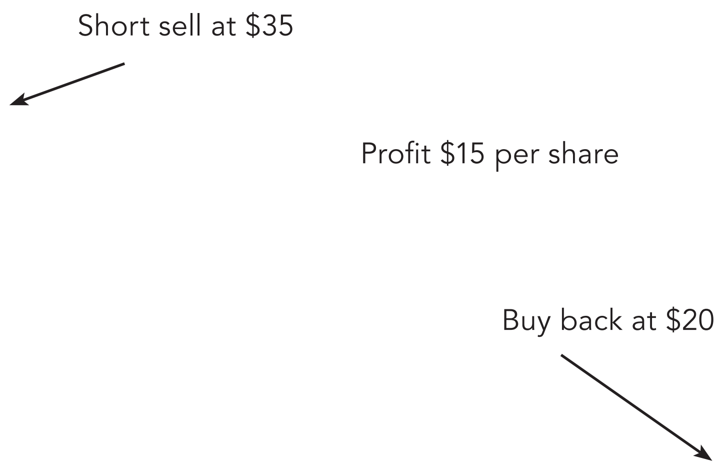


Imagine that Facebook is being traded at $35 a share. You find that Facebook is overvalued and on a downtrend and believe that it will decline to $20.

You can short sell Facebook shares at $35. This means that you sell Facebook shares without owning any in the first place. What happens is that your broker will borrow the shares from another investor and lend them to you to be sold.

If Facebook declines to $20, you can buy the shares back (buy to cover) and return them to your broker. By selling short at $35 and buying back at $20, you will receive a $15 profit per share.

Chart 10.2: Facebook Chart 2012



Credit: www.thinkorswim.com, ProphetCharts®

You can only short sell shares directly on certain markets like the US exchanges. Before shorting, check with your broker that the shares can be borrowed for shorting. Brokers like www.thinkorswim.com will list down shares that you can borrow to short. The lending rate you pay varies from 2% to 7% per year, depending on the popularity of the stock. Do take note that you need to open a margin account with a broker in order to go short.

Risks of Going Short

Many traders I know love to make money by shorting declining shares. The reason is because shares tend to fall much faster than they appreciate. Hence, they find that they can rack up profits much faster going short than going long.

However, you must be aware that short selling is highly risky if you do not cut your losses in the event that the stock goes up instead of down. Theoretically, short selling can lead to unlimited risk of loss!

For example, if you short sell Facebook at $35 and it goes up instead, you will start to lose money! There is no limit to how far up Facebook can go. If the company suddenly reports great earnings and future potential, the stock could go up to $100, $500 or even $1,000 per share! If you don't buy back the shares, your losses will keep going up.

This is why you must always place a stop-loss 5% – 8% above your short sale price. For example, if you short sell Facebook at $35, you need to place an order to automatically buy the shares should it rise to $37.80. This order is known as a **'stop market order to buy'**.

Going Short with CFDs

Asian markets like Singapore, Malaysia, Indonesia and Hong Kong do not permit short selling of stocks directly. In such cases, we can still go short by using derivatives such as options, warrants and CFDs. In this chapter, I will only be focusing on using CFDs to go short.

For example, if you think that UOB shares will decline in price from $20 to $18, you can short sell 1,000 UOB CFDs. This means that you are taking a short position of $18 × 1,000 = $18,000. Simply hit the 'sell' button on the CFD brokerage platform you are using.

If you use a 10% margin, you will have to put up a cash collateral of $1,800. If UOB shares fall to $18 and you buy back to cover your position, you will receive a profit of $2 × 1,000 = $2,000.

When you take a short position with CFDs, you have to pay the usual financing charges as well (just like long positions). However, should the company pay a dividend during the time you are short, you will have to pay the dividends due to the broker. Let's take a look at an example of a typical short transaction.

Case Study: Going Short with CFDs

On 30 May 2012, Marvell Technology Group (MRVL) reversed to a downtrend when the 50 DMA crossed below the 150 DMA at $12.65. At the same time, the daily price candles broke below the support line at $13 (a bearish sign). It was the perfect shorting opportunity!

I decided to sell short at $12.65 and put a stop-loss at $13.50, one candle length above the $13 support line (which has now become a resistance line). My risk per share was $12.65 - $13.50 = -$0.85.

Note: When I short a stock after it has broken a support line, I will put a stop-loss one candle length above the support (now becomes resistance). Similarly, if I long a stock after it has broken above a resistance line, I will put a stop-loss one candle length below the resistance line (now becomes support).

Chart 10.3: Going Short on Marvell (MRVL)

Credit: www.thinkorswim.com, ProphetCharts®

My profit target was \$10.40, since it was a strong support level. My profit potential per share = \$12.65 - \$10.40 = \$2.25. Below are my workings:

Initial capital \$100,000
Risk per trade 3% of capital = \$3,000
Risk per share = \$0.85, Profit per share = \$2.25, Risk-to-return = 1:2.6
No. of shares = $\frac{3\% \times \$100,000}{\$0.85}$ = 3,529 shares

I short sold 3,529 MRVL CFDs at the price of \$12.65.

My short position = \$12.65 × 3,529 = \$44,641

Since CFDs allow me to put up a margin of 10%, my cash investment was 10% × \$44,641 = \$4,464

My financing (interest charge) was 2.15% per annum at the time. So, the interest charged per day was (2.15% × \$44,641) ÷ 365 = \$2.63 per day

I had to pay broker's commission of 0.15% of my contract value. So, my sales commission was 0.15% × \$44,641 = \$66.96

In 52 days, MRVL declined to a low of \$10.29 before rising again. To protect my profits, I bought back the CFDs at \$10.80

I bought back MRVL CFDs for \$10.80 × 3,529 = -\$38,113

I had to pay my broker a commission of 0.15% × 38,113 = \$57.17
For holding my position for 52 days, I was charged a total interest of \$2.63 × 52 days = \$136.76

My net profit worked out to be +\$44,641 - \$38,113 - \$66.96 -\$57.16 - \$136.76 = \$6,267.12

Since I only invested \$4,464 in cash,

my rate of return was $\frac{\$6,267}{\$4,464} \times 100\% = 140\%$

Choosing Stocks to Go Short On

In order to diversify my portfolio (which is usually made up of long positions) and to take advantage of falling stocks and indexes, I would go short on certain stocks at certain times. There are five conditions that I look for before going short on a stock (or even an ETF).

1) Stock Is on a Confirmed Downtrend

I only take on a short position when the stock in question is on a confirmed downtrend. The 50 DMA should be below the 150 DMA and both moving averages must be sloping downward.

2) Stock Is Overvalued and/or Hit by Very Bad News

Ideally the stock should be selling at a price above its intrinsic value and is suffering from deteriorating profits. I especially like to short stocks that are hit by very bad news that will take a long time to resolve. Fraud and accounting scandals usually spell the demise of most stocks. These are the best ones to go short on. They take years to resolve and in the meantime, the stock would only be pressured downward.

One of the favorite stocks shorted by traders has been Groupon (GRPN). Suffering from declining sales and profits, Groupon has plunged 83% since its IPO. Going short on Groupon would have generated an 830% profit using CFDs.

Chart 10.4: Groupon (GRPN) Chart Nov 2011 – Oct 2012

Credit: www.thinkorswim.com, ProphetCharts®

On 23 Oct 2012, I went short on Monster Beverage (MNST) after it was reported by the FDA that five people may have died after consuming its popular isotonic drinks. Although it was a very unfortunate incident, it does give the short seller a profit-making opportunity.

Chart 10.5: Going Short on Monster Beverage (MNST)

Credit: www.thinkorswim.com, ProphetCharts®

3) Stock's Next Support level Is More than 2× below Current Price

Before shorting a stock, I would want to make sure that it has the potential of declining more than double of my stop-loss distance. After all, every time I take on a position, I need my risk-to-return ratio to be at least 1:2 to make it is worth the trade.

While there is no way to guarantee how low a stock on a downtrend can go, it is usually helpful to look at support levels. The next support level will tell you where the stock price will probably fall to before buyers start rushing back in.

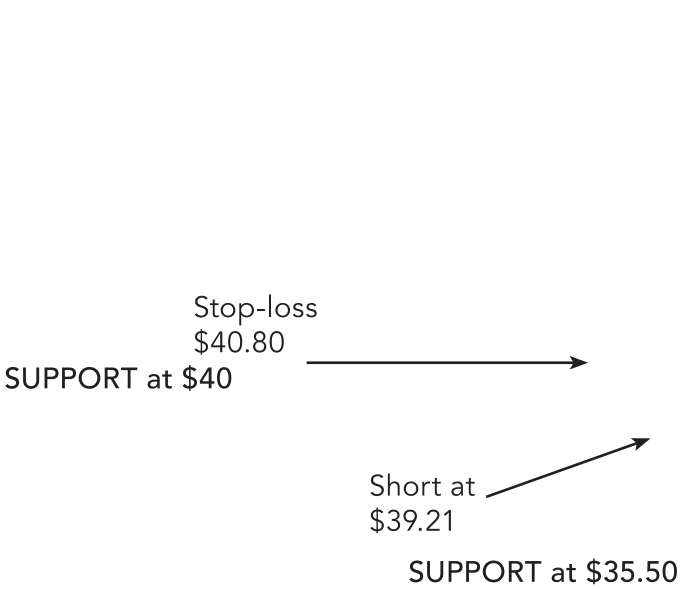
For example, I decided to short Garmin (GRMN) at $39.21 after it broke the $40 support level on a downtrend and placed a stop-loss at $40.80.

My stop-loss distance (also known as risk per share) = $39.21 - $40.80 = -$1.59

The next support level was at \$35.50. So the distance to the next support level = \$39.21 - \$35.50 = \$3.71

This is a worthwhile trade since I would be risking \$1.59 to make a potential \$3.71. The profit distance was twice the stop-loss distance.

Chart 10.6: Going Short on Garmin (GRMN) 2012



Credit: www.thinkorswim.com, ProphetCharts®

Now that you have learned how to short stocks (and even ETFs), you will be able to find profit-making opportunities in any kind of market. Whether the stock market is in a bull run or in a bear run, it really makes no difference to me. Either way, I will make money as long as stocks and ETFs move in a particular direction.

Using long, short and leverage strategies is the way successful hedge fund managers generate huge returns for their wealthy clients in any market situation. Now, with this powerful knowledge, you can begin to do the same for yourself.

Your Journey Has Just Begun

I hope I have shared with you a sufficient amount of ideas and strategies to get you started on your journey as a successful investor/trader towards your ultimate goal of financial freedom. The most important thing you need to do is to take action on these ideas and turn your inspiration into results!

Always remember that knowledge and information alone will not make you rich or change your life. It is only when you apply what you learn and take massive action will positive changes happen in your life. So, start by revising what you have learned, opening a brokerage account, reading the financial news and analyzing stocks. If you are not ready to invest your cash, start by opening a demo account with any credible broker and placing some paper trades to get your momentum going.

While I believe I have shared many powerful techniques with you, do understand that it really represents the tip of the iceberg. This is why I passionately conduct my *Wealth Academy™* program once a quarter to train people from all walks of life to become successful investors and develop the other essential money skills to free themselves from the rat race.

If you are truly committed to mastering these skills and are willing to put in the hours to be mentored through hands-on practice and step-by-step guidance, do join me in one of my upcoming programs. It would be my honor to further serve you on your quest to financial success.

I wish you all the very best and thank you for taking the time to read this book.

Adam Khoo

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