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From the Author of

"Winning the Money Game"

Sean Seah Presents

Gone Fishing With Buffett



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INTRODUCTION

"Put your money to work!"
"Buy Assets!"
Even before I entered the business school as an undergraduate, I have heard many of such advice. "Financial literacy" is becoming a popular term and everyone I know seemed to have at least read "Rich Dad, Poor Dad".
Thus, the idea of needing to invest is something that most people are familiar with.
The question for most people would be "What assets do I buy and how do I get started in investing?"
This book provides you my experience investing in the stock market. I have chosen to take my younger brother, Samuel's suggestion to write it in a story form, because I see a strong value in stories.

This book is a simple story about how a young man learnt to invest from a successful old investor. I wrote it in a manner that if a friend comes up to me and asked me to guide him to invest, I would assume the role of the old investor and guide him through like he is the young investor.

So while reading this book, imagine that you are sitting beside me at the jetty, facing the sea, or if you prefer, as if we are sitting down at a café. And as a personal friend, I am there to share with you my all my experience from stock market investing.

Some years back when I started venturing into the stock market, I experienced and suffered losses that were the result of ignorance and greed. And in the midst of all that, the concept and methods of Value Investing had been introduced to me through a friend, but I took very little interest in it and placed a small portion of my money to work via the 'Buffet way'. This is because it does not seem to be able to get me rich..... quick. To me, Value Investing seemed slow and boring because I associated it to Warren Buffett. And in my mind, Warren Buffett only became rich after decades of investing and I am not willing to wait for such a long time.

It was only when I started comparing the results I have gotten from Value Investing to the other methods I used, I was astonished how stable my returns were and how little time I had actually spent using Value Investing.

I have trained hedge fund managers in Trading using Technical Analysis rather than Value Investing and I have seen 100 different results from 100 different traders. And sad to say, most of them do not make consistent profits. The key word is "consistency", as the results have proven themselves in Value Investing.

Beside the stable returns and the little time needed, what I really like about Value Investing is that it is highly duplicable, when one takes on the mindset of buying businesses from the stock market instead of speculating and being worried about the short term performance of the stock price.

I have embedded a bit of my personal story of how I fell in the early days of venturing into the stock market and this is in the hope that those who have gone though similar experience can relate to it and continue to invest. And for those who have not experienced how vicious Mr Market can be, this book will bring to your awareness how the stock market works I will like to encourage you to first invest in yourself and gain the proper knowledge before diving into the stock market for a 'quick buck'.

At the end of some segments, I have included an 'Author's Note' to share with you some of my personal experiences or to explain some technical details. These notes will help you better understand how to apply what you learn from the segment.

As in my previous book, I am open to receiving any feedback, questions and sharing of your personal experiences, be it lessons or success stories.

To your dreams and God bless you,

Sean Seah

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Part 1: The Bait

DOWN

Sean, a 26 year old young man, walked to the edge of the jetty and stopped.

He stared at the horizon blankly, "Why had all these happened to me? Why didn't I listen to Prof?"

"Most People cannot beat the Market, so don't even Try!"

The words of Sean's Professor hit him like a brick and his heart sank. The memories of the time when he was a young undergraduate in one of the Prestigious Business School replayed in this mind.

Back in school, Sean attentively copied notes in his Finance and Investing class. He was second year in the university and Finance and Investing is by far his favourite subject. His Professor was engaging, humorous and most importantly, Sean felt: "At last, I am learning something that I can actually use!" He had always been doubtful and sceptical about the education system. "Well, I don't remember the last time I used Pythagoras' Theorem for any practical usage. But now, I am learning how to invest in the stock market and make some money!"

Sean was an attentive student in Business School especially in the class of Finance and Investing. He compiled notes and investment ideas from the Professor and in his mind, he was going to use these ideas to invest and grow rich once he graduated from the business school. All he needed was to find a job that would pay him so that he could finance his investments.

At the end of final tutorial, the popular and well liked Professor received standing ovation as his passionate teaching and humour made him stand apart from most of the serious, boring tutors. He had won the hearts of the students. He smiled widely and stood there enjoying the appreciation showered on him. After the applause stopped and the echoes that trailed ended, he signalled for silence and scanned around the classroom sternly. Then he delivered his parting words, "Class! After all that I have taught you, I need to warn you.

Most People cannot beat the Market, so don't even Try!" These words boomed in Sean's ears. He couldn't believe what he was hearing. Probably to most of his classmates who had taken notes just to pass the exams, these words from the Professor meant very little. But for Sean, his orientation was very different. He had learnt to invest and the amount of confidence he had built over the past months was badly shaken. He felt puzzled and upset. But he was not willing to let his hopes be dashed by a mere statement, even though it came from someone with great credibility and strong academic background. He decided to do some of his own research.....

CAN'T BEAT THE MARKET

"That is what Prof is trying to say." Sean felt enlightened. He did some research online and read books about the stock market. After his own intensive study, he realised that his Professor was right after all. Statistics showed that most of the professional fund managers have not been able to beat the market consistently! Although different studies showed slightly different results, almost all the studies found out that 70% of the funds managed by professionals have not been able to beat the market over the long run.

With the advice of his Professor and the reinforcement from his studies, Sean silently decided in his heart that he will avoid the stock market at all costs. After all, if the professionals cannot beat the market, what made him think that a small retail player like himself can do it?

Author's Note:

I thought it is important at this point of time to explain what it means when my Professor say that most people cannot beat the market.

The Market

Firstly, what is "The Market"?

There are times where we hear the news reporting that the Singapore stock market is up by certain number of points or down by certain amount of points. The market is commonly represented by Stock Market Indices.

There are quite a number of stock market indices and a stock market index is computed with a combination of stocks, usually from different industries. For example, in the US, there is an index known as the Standard and Poor's 500 Index which is computed by combining 500 largest U.S Stocks. Each day, as these 500 stocks' prices change, their average movement is computed to represent the US stock market.

This means that while some stock prices go up, some go down and some remain unchanged, the index will account for all the movements and average it to represent the market.

These indices serve as a benchmark for most fund managers.

There are several studies out there which state that most Professionally Managed Funds (Mutual Funds, Hedge Funds, Unit Trusts), have not been able to outperform these indices consistently over the years. The top performing

funds usually are not able to remain at the top. Their performance may beat the market indices for one year, maybe two year, but in the long run, it seems that the market always outperform most of these funds.

Buy The Market!

So if you want to buy into a managed fund, you may choose to think twice and perhaps buying the market may be a better bet. There is the Exchange Traded Funds (ETF) that tracks the Market Indices and mirror the performance of these indices.

For example, you can buy the STI ETF to Track Singapore's Market which is represented by the Straits Times Index. Or you can buy SPY (known as the Spider) to track US's Market which is represented by the S&P 500 index.

The interesting thing about most of these ETF is that you do not even need to play management fees as no one is really managing these funds. In the case of managed funds, you have to pay management fee regardless whether you win or lose money. That being said, you have to take note of the unavoidable fees such the brokerage fees.

TRAINING FLEAS

After graduation, Sean found a good paying job. And even though he would participate in the discussions regarding the stock market whenever his colleagues talked about it, he could not bear to put a foot into the stock market. After all, his Professor and his research told him that the chances of him, an average person, beating the market was close to slim. His thoughts were firm, "If even the professionals cannot do it, what makes me think a part-time investor like me can make any money from the stock market?"

By this time, he had started a family with the lady he loves and they have a baby boy to feed. With a well paying job and many bills to pay, there was no way he was going to risk any of his hard-earned money. In fact, whenever he participated in discussions regarding the stock market, he would strongly advised people to stay out! "Most People cannot beat the Market, so don't even Try!"

One fateful day, Sean and his colleagues were having lunch break and they were discussing about the latest movers and shakers in the stock market. Nearing the end of the conversation, Sean again, gave his peers the advice his Professor gave him 4 years back, "By the way guys, *Most People cannot beat the Market, so don't even Try!*" His peers listened and nodded in agreement. Sean was a figure of a successful young man and with a good academic background from a prestigious business school, his words had credibility.

One of his friends, Suffian, was a seasoned investor. He noticed that all the rest were agreeing to what Sean said, could not help himself and raised his voice slightly in order to gain the attention of the group.

"You are right, Sean. **MOST** people cannot beat the market..."

Then, he paused to make sure everyone was listening before delivering his punch line.

"Because... **MOST** people do not **KNOW** how to."

"Oh, you sound pretty confident Suffian. Do **YOU** know how to?" Sean challenged. Sean had grown strong in the belief that no one can beat the market and he was not ready to drop this belief, especially this was coming from someone who did not even have a Business Degree.

"Well, I guess results speak louder than words. If you guys don't mind, I can show you my brokerage account with all my trades. I started about 3 years back." Suffian offered.

That got the entire group excited. Most of them, like Sean, talked about the stock market but had not even opened a brokerage account. So seeing a live

brokerage account to them was like introducing military tanks and weapons to a group of young men.
"What does this figure mean?" Sean pointed to an amount that was displayed on the screen.
"That is the amount I can take out from the brokerage account if I sell away all my stock holdings right now." Suffian explained.
"What?! You have a quarter of a million in your account?" Sean exclaimed, obviously impressed.
"Yep, that's right" Suffian replied in a casual tone.
"And how much did you started with and how long did you take for you to do that?"
"As mentioned, I started 3 years back. And I started with about \$40,000 which was my entire savings."

That was all Sean needed, a personal friend who showed him that it is possible to beat the market. Suffian was only 25 years old back then and he had accumulated about a quarter million from the stock market.

"How? How did you do it?" Sean pleaded Suffian to teach them.

With the remaining fifteen minutes, Suffian shared his experience and gave the group a list of resources which included the Business Times, a few websites and a few recommended books.

Sean spent the next few weeks consuming the resources given to him. In his mind, he would devote the next few years of his life to becoming a stock market expert so that he can beat the market and grow rich. He aimed to be a millionaire... no, he will be a multi millionaire or even billionaire.

After reading though the resources, he still felt inadequate. He had opened up a brokerage account and had funded the account with his money. He had also approached Suffian a number of times to ask him for some more hints and to show him the directions. But before he could ask further, Suffian left the job and became a full time broker instead. Sean and his peers were not surprised. Why would a young successful investor like Suffian stay and work for someone else?

Even though Sean had not learnt anything explicit from Suffian, he learnt a lesson that is far more important. He learnt that it is POSSIBLE to beat the market, if you KNOW how to do it. It is one thing to read in the papers or books that a person became rich through investing. It is a whole different feeling when someone you know at a personal level does it before your eyes.

Sean was hungry for the knowledge of investing. He now knew that it could be done, he just needed to find out how. He began his search for the legendary, Holy Grail.

Author's Note:

I once heard motivation speaker Zig Ziglar said that in order to reach your goals, you have to be a Flea Trainer –hence the title of this segment, Fleas.

If you take a glass jar and put Fleas in it, you will be able to observe that they will attempt to jump out of the jar. Hence, what you should do is to put the cover on. What is interesting is that as you continue to observe the fleas, you will see them continuously jumping and hitting onto the 'ceiling', which is the jar cover. You can either continue to stare at them for 30min or you can go and carry on your work and come back 30min later, but what will happen 30min later is *astonishing*!

30min later, when you return to look at the jar, you will see that the fleas will still be jumping. But they will no longer be hitting the ceiling. In fact they will jump to a height that is just below the ceiling. At this point of time, you can remove the cover of the jar and guess what? The fleas will continue to jump hard, but they will never jump out of the jar. They have been conditioned to believe that there is a ceiling and they will not be able to jump out!

How many of us still believe that there is 'ceiling'? What my professor did for me was to place a 'ceiling', or a limiting belief in my mind. I reinforced it with my research. And because of that, I never dared to invest in the stock market because I was conditioned to believe that it cannot be done.

Meeting Suffian was an important part of my life, because what he did for me was to 'break my jar' and free me from my limiting beliefs.

What are your beliefs about the stock market? What are your beliefs about making money from the stock market?

I used to believe that the stock market is not a place for me to venture into and that investing is gambling.

In order for you to become a better investor, it is important for you to take stock of yourself, and notice what is helping you and what is stopping you.

For e.g., my belief that to invest in the stock market is a form of gambling stopped me from even trying to understand how it is possible to invest properly. That did not help me as an investor.

And interestingly, I found out that whenever you go and look for evidence to support your belief, you will usually find them. Just like when I went to find out if it is true that most people cannot beat the market, I find many evidences that it is true.

After I met Suffian, I began to realise that while it is true that most people cannot beat the market, it is also true that there are also many who consistently beat the market because they used proven methodology that makes so much sense. I guess, whatever you *choose* to believe, you will be able to find some sort of evidence to back yourself up. So choose your beliefs wisely. Choose those that empower you, not those that dis-empower you.

With that, I have a big warning for you. Please read on. 2

HOLY GRAIL

[Proven Trading System that Makes You \$10,000 your first month!]

[I sacked my boss and trade full time after attending XXX's course]

[Using this Proven System, we have the most full time traders who quitted their jobs.]

"Wow! I wonder which course I should attend. There are so many of them out there!"

Sean was looking through the newspapers and surfing the web for a course he could attend. He needed someone to teach him and he decided to learn from someone credible, someone who had 'been there, done that'. He wanted to cut short his learning curve and make a million within the shortest time. After all, Suffian made his quarter million within 3 years.

He started attending Stock Market Courses' workshop previews and decided on a Trading course which cost \$5,000, taught by a self made millionaire who made his millions in the stock market using a secret system.

The trainer said confidently, "If I can do it, so can you. All you need to do is to follow the system I use. Why go and reinvent the wheel. Just follow the system and make millions like me!" That sounded totally logical! Sean bought a new laptop and attended the 3-day workshop that stretched over the weekend.

After 3 days of looking through several charts and indicators, the entire class were ready to quit their jobs and become millionaires. "When all the indicators ask you to buy, what do you do?" asked the Millionaire Trainer.

"BUY!" yelled the class. "Good! And when the indicators ask you to sell, you..."

"SELL!" came the reply.

The Trainer smiled and was pleased with the attentive crowd. Towards the end of the class, he ended by saying, "Very good, all of you now have the secret weapon to go out there and make money from the stock market. You are now so much better equipped than the 99% of the people in the market. The only thing is to actually follow the system strictly! If you follow it, you will be rich within a very short time. So if you find yourself losing money, there is only got to be one reason, and that is YOU did not follow the system! Remember that in trading psychology is 80%. The other 20% is the strategy and money management! So let me emphasize again, if you start losing money, you should not twig the strategy nor the money management, the only thing you need to twig is?"

"ME!" the class responded.

After the workshop, Sean was so excited from the fact that he was now equipped with the knowledge and skills to make money from the stock market. He called 2 of his close friends, Adrian and Daniel immediately and told them, "Hey dudes, do you guys want to make money? I just completed the Trading Course and it is great! I am going to make some huge bucks. Do you want me to help you as well? I can pool our money together and be rich together!"

"Wow! Thanks a lot. I will transfer money to your account later." Both friends trusted Sean and together, they pool together a tidy sum of about \$100,000.

So with the confidence that came with ignorance, Sean nose-dived into the stock market.

THE HYPE, BITES

Sean stared at the computer screen. He just made \$5,000 from his first trade.

"Yes! This system is really solid. I just need to follow the rules." Sean's confidence grew and he celebrated. He told his wife that they are going to be rich, and soon they can afford things they had only dreamt of: a nice convertible, a water front condominium for themselves, as well as for their parents. It is nice to know that you can afford to spend extravagantly on your loved ones. For the next few weeks, he also went around sharing what he had learnt so that his friends could benefit as well.

Few weeks later, Sean was experiencing a feeling known as 'fear and frustration'.

"What?!" Sean yelled. He had just lost 3 trades consecutively and his capital depleted by another 20%. "I know I can make it back, just follow the system.... Follow the system!"

It had been 6 months since Sean started trading, and it was affecting his life. His emotions are very much affected by his trading results that day. When he won trades and made money, he was a loving husband, a caring dad and a

boastful friend. He would tell his friends how much he made in a short period of time. But when he lost money, he became a stranger to his family and would keep quiet about his losses. When his friends asked him why he looked so glum that day, he would brush them off lightly and mention something about being busy or that he was not feeling well. His ego did not allow him to admit that he was losing money in trading.

Sean became very much 'addicted' to trading. When he made money, he wanted to work harder and make more, and when he lost money, he wanted to make the losses back fast. He studied the markets, the news and read up about different trading styles and systems. He even attended more trading courses to find a system that really works.

About a year later, he lost most of the money he pooled together from his friends. Despite losing most of the funds, he did not tell his friends, mainly because he did not know how to. They had trusted him and gave him their money. He also had no idea what to say to his loving wife who kept encouraging him with words of assurance, "Do be too stressed up, I know that you can make it." How could he tell her that he lost most of their savings? How will he be able to explain that he had cashed out their child's education and life policy to trade the markets, and lost?

Sean felt horrible. He felt like a loser. He felt as if his dignity and pride as a friend, a husband and a father had been robbed from him - by the market. He needed to escape and be left alone. Every day, he will find a place to 'hide', so

that could 'strategize' and think of how to recoup his losses. It was just another day when he walked aimlessly along the beach and before he knew it, he was at the jetty, staring into the horizon blankly. What he did not know was that this day was another turning point for him, because he was going to meet a very special fisherman.

Author's Note:

Every once in a while, I would meet into people who tell me that they have attended a Stock Market or Forex Trading course and they are quitting their job to be a full time trader.

For those who have read my book, "Winning the Money Game", you would have read on the part where I started venturing into the stock market after one of my friends, Suffian, showed 6 of us that it is possible to make money from stocks. After our talk with Suffian, I began searching.

To my excitement, I found many courses that promised me that I can get rich quick, quit my job, be a full time trader etc.

I paid about \$5,000 (I think), joined the course and became confident. I traded some money and won. My confidence grew, so the next step I did was to be a nice and kind person and asked 2 of my good friends if they want to make money as well. They said yes, so I took their money and graciously lost about 50% for them.

I will never forget that feeling.

But I didn't give up. I attended more courses and lost more money. The funny thing during the time I was trading was this — I identified myself as a Trader. I began to feel good about trading. I read books, attended courses, traded every night. I honestly want to find the "magic" system, strategy, methods... whatever you call it.

Years later, I have arrived at a stage where I began to understand the stock market much better, so much so that I can make consistent profits. Interestingly, it is done not using any of the techniques taught by me from the courses I attended, but through guidance from personal mentors, many books and lots of practice.

Looking back, I do not think it is fair to say that those courses I have attended are fraud or scams. These courses do teach the participants some amount of skills and knowledge based on the trainers' experience. And in my opinion, if you need guidance in Trading, it is probably a good idea to get someone to help you get started.

BUT! What ANGERS me is the HYPE in all the marketing! Statements such as those below are beginning to become more common:

"I made 700% in my first trade!"

"After attending the course, I made my first 3 trades and made \$75,000!"

(Do note that this book is published in 2011, so if by the time you read this and you do not find claims as such common, I would say that the authorities have probably cleaned up some of these hypes.)

HYPEsss! I hate to wake you up from your dreams! In fact those of you who had attended such courses would probably have woken up!

I recently brought my 2 boys to a drum class. And without a single bit of biasness, they are excellent and had so much potential, just like their dad. But

even then, I am clear headed enough to know that they need more than a few drum sessions to become professional. Being a Professional Trader is the same, it takes practice and probably years.

Dr Alexander Elder, best-selling author of "Trading for a Living" mentioned that if you just started trading and manage to break even after a year, you have done extremely well. So for those who just started trading and you are promised 20% to 50% per month consistently, please think carefully.

In March 2011, I met a nice elderly gentleman who is a manager at Philips Capital. He used to be a Professional Institution Trader. He had traded millions, and he had made and lost billions. He told me that when he saw those claims from Trading Courses, he is wondering: "Why the authorities are not doing anything to clamp these guys down?" (His exact words). He knew that it is not possible for anyone to make money consistently as claimed by these advertisements.

But even with this note and with the newspapers journalists warning people, there will still be many who just "see and hear what they want to see and hear", specifically: "how to get rich quick over night and how to be able to sack their boss 3 months from now".

If you want a real solid plan on your financial destiny and really want to learn how to invest (not get rich quick), then I am here to share with you. Because I have been through the pain, I understand the feeling and frustration. I see many of my initial trading course mates having a worse life because of the

courses we attended.

It is my appeal to you: To be a wise, Intelligent Investor, not a greedy blind mouse. Take a moment to pause and observe your feelings and be honest to yourself.

Are you willing to take the effort to learn?

Are you willing to W.A.I.T. (By the way, W.A.I.T does not stand for anything, it just means wait. I wanted to create the pause effect after each alphabet, just to make you wait).

Ok, after all these, I do have good news. If you are able to just take time to learn, you can in fact "get rich quick". Probably in 3 to 10 years' time! And let me tell you a secret, 3 to 10 years is QUICK! And it really depends on the initial capital you have and the condition of the market at the time you are reading this. Some people I met became rich really quick. A partner of mine, Liu Feng did become a millionaire within a relatively short period starting with very little. What these people did was to first invest in themselves by learning how to buy stocks using Value Investing. And they repeated the process until rich. Sounds simple? It is that simple.

Are you ready to take the first step to learn and use Value Investing? I know you do; otherwise you wouldn't be reading this. So let's move on to the next chapter where the lesson proper begins.

In the meantime, Don't Let the HYPE Bite You!

Part 2: The Fisherman

HOPE

"Hey sonny, the fish won't fall into your bucket, you have got to go out there and get it!"

"Huh. What?!" Sean came out of his trance state when an old gentleman who had been fishing near Sean spoke.

"I am saying that you can't make the fish come to you by just staring into the sea, you need to go out there and get it, like this! Haha!" The old man laughed as he tugged at his fishing rod. At the end of the line, a fish that the old man had skilfully caught surfaced from the waters. He then smoothly pulled the catch towards him, and with one single movement, placed it into a bucket.

Sean was impressed, "Wow! You are a pretty good fisherman, sir!"

"Well, thank you sonny. It all begins by throwing the bait into the sea." replied the old man.

"What do you mean sir? Of course, you will need to put throw the bait in, to catch the fish."

"That's right, sonny. You look troubled just a moment ago. And the solution to your troubles won't come to you unless you go out and throw your bait in. In order words, you have to go and do something about it. Worrying seldom gives you the solution." The old man grinned as he took a bite on his burger, which was probably his breakfast.

Before Sean knew it, he found himself sitting down beside the old gentleman and sharing what he had experienced. The old man continued to fish but listened attentively to Sean. From time to time, the old man gave a nod to acknowledge that he understood and this was usually followed by a munch on his burger and sip from his coke can. Sean did not know who this old man was, but he could sense deep wisdom and kindness in him. That made Sean felt a sense of security. It seemed as if this old man could empathize with him.

"And before I know it, I lost huge amounts of our money... and I..." Sean sighed. He tried to find something to say to complete his sentence, but felt himself choking inside. He was almost holding his tears back.

"And you have infringed Investment Rule Number 1!" The old man chuckled.

"Investment Rule Number 1? What is that?" Sean regained his composure. It seemed as if the old man would always step in to break them out of a negative atmosphere with his weird comments.

"Aha! There are 2 very important rules in investing. If you stick to them, you will be a successful investor. But if you infringe them too many times, you are sure to be poor." With that, the old man stopped speaking and continued fishing. Sean grew curious and innocently asked, "Sir, do you dabble around with stocks as well?"

"Dabbled with stocks? I do not dabble around with stocks." The old man replied in a sharp manner. "What I do is to INVEST."

"Oh, I am sorry for my choice of words." Sean apologized, after the old man displayed his disapproval. "Have you been investing for a long time?"

"Well, I made my first investment at age 11. I was wasting my life up until then." The old man laughed. It was obvious that the old man had huge passion and a wealth of experience for investing. And for Sean, it looked as if the old man was willing to share an investment secret with him, the so-called Rule Number 1 and 2. He was desperate to win money back so that he could face the people he felt accountable to. Thus, Sean humbly asked, "Sir, so what are Rule Number 1 and Rule Number 2? Will you be willing to share them with me?"

"Ah yes, we were talking about the 2 most important rules in investing. Here, listen carefully." The old man lowered his voice while signalling Sean to come closer. Sean obediently followed and leaned over. He was excited that he was going to be led into the greatest rule in investing.

RULE #1

"When you go out there and put your money to work, always remember these 2 rules:

Investment Rule Number 1: Never Lose Money
Investment Rule Number 2: Never Forget Rule Number 1

"What?!" Sean exclaimed in disappointment. "This is the most important rule? To Never Lose Money?"

The old man sensed Sean's disappointment but was not surprised. He ignored Sean's casual remarks and continued, "When you break Investment Rule

Number 1, you must understand the damage that you have just incurred. Let me ask you this, if you lose 50% of your initial money, how much returns must your remaining money make in order to recover your losses?"

"If I lose 50%, I will need to make 50% back," Sean replied without much thought.

"Most people go into the stock market aiming to make a lot of money but they are not aware of how damaging losing money is. Let us put some real figures in. If you started with \$100,000 and you lose 50%, how much are you left with?"

"Well, if I lose 50% of \$100,000, I am left with \$50,000" Sean replied, but he was really interested in learning why he shouldn't lose money. He wanted to know how to make his losses back; he wasn't interested to be reminded of how much 'damage' he had incurred.

"And for your \$50,000 to grow to a sum of \$100,000, how much return must it make?"

"\$50,000 to \$100,000, isn't it 50%? Hey wait! It is 100%!" Sean's eyes widened. "So I need to make my money work doubly hard in order to make back what I have lost!"

The old man smiled. "And that is one of the main reasons why when I choose to invest my money, I only invest when I know I will not infringe Rule #1."

"But how can we not lose money when we invest. In order to have some returns, we need to take *Risk*, don't we?" Sean challenged.

RISK

"Sonny, most people think that in order to invest in the stock market, you need to take on huge amount of risk. But let me put it this way: risk, comes from not knowing what you are doing."

Risk comes from not knowing what you are doing.

Sean stared at the old man and the old man looked straight back into Sean's eyes. Sean was amazed. Just a few minutes ago, this old man seemed so insignificant fishing at the jetty. But all of a sudden, he seemed so wise and had so much to teach. Sean requested, "Can you explain more on what you meant?"

"Sure. You see, risk is contextual. If I were to challenge you to climb Mount Everest today, will you do it?" the old man asked.

"That will not be feasible. It is too risky!" Sean replied.

"You are right, neither will I." the old man smiled. "But what if I offer you a million dollars, will you do it?"

"A million dollars! That is really attractive. But to be honest, I don't think I will make it alive."

"Good, but what if I extend the challenge to be a 1 year challenge? Will you take up the challenge?"

"1 year? One million? I will definitely take up the challenge!" Sean replied.

"Interesting. Didn't you mention a moment ago that it is too risky? What difference does it make if I give you an additional 1 year?"

"Well if you give me 1 year, I will go and learn from the best coaches, start training, get the best equipment and so on." Sean could already picture the things he would do in order to get himself prepared.

"Well well, so after you go through all this, isn't it still risky to climb Mount Everest?"

"The risk would probably still be there, but it will be significantly lesser because I will be more prepared."

"So, am I right to say that to someone who does not know how to climb mountains, climbing mountain is risky. But for a well trained, well prepared professional, the risk is much lesser because they know what they are doing?" The old man directed Sean back to his initial point.

"Ah, I see the point now." Sean agreed. He then paused for a moment as if he was missing something and then he remembered, "But sir, I do understand from my research that most Professionals cannot beat the market consistently. So as well prepared as they are, investing is still risky for them isn't it? Otherwise, they should have been beating the market."

The old man chuckled. "You are right, most so-called professionals can't beat the market. And even so, the stock market is the only place people who drive Posche take advice from people who take the subway."

The stock market is the only place people who drive Posche take advice from people who take the subway.

"But these people are professionals aren't they? Shouldn't they know what they are doing?' Sean challenged.

"Sonny, they do know what they should do. Unfortunately, they are not able to do what they know they should do." The old man replied.

"You are getting me all confused here."

"Well, you see, investing is really simple. What we do is to buy businesses with good to exceptional economics and buy them at a sensible price. That is all I do. And then I wait for the market to realise the value of the business and price it up."

Buy businesses with good to exceptional economics and buy them at a sensible price.

"Buy Businesses? At a sensible price? Do you mean looking at the fundamentals of the stock? I have attended stock market courses and was told not to bother about the fundamentals of the stock and these are professionals who made millions in the stock market."

"These are people I am talking about. They know which are the businesses to buy and they even know what price would make the deal a good one. But instead, they are very much short term biased. So they try to predict market movements and make a killing in the stock market. Well, so far, how has that been working out for you?"

"Not very good, sir. Like what I have mentioned, I have broken investment rule #1 big time and lost a lot of money." Sean replied. "So why don't the professionals do like what you say, buy good businesses at sensible price? Why do they try to predict the market instead?"

"Well, most of them are pressured to perform in the short run. But in the short run, the market is not rationale and stock market would price the businesses based on news and speculation which they always over react. Sometimes, the price of the business will dip just because of rumours that the CEO is having health problems. And price will rise when an analyst write something great about the business. The fact is, how good or bad the business is not really affected by these rumours, but the price of the stock swings uncontrollably like wildfire. And that is very common in the short run. This is in fact good news, otherwise, there won't be much chance for investors like me to buy good businesses at a discount."

"But don't you want to make money in the short run?" Sean asked.

"I want to make money surely." The old man answered. "I buy businesses with the assumption that the stock market closes and will not open for the next 5 years. In the long run, the market is a weighing machine. It sooner or later realise the actual value of the business and adjust the price to reflect how much it is worth."

"Wow, does that always work?" Sean was impressed with what the old man had shared. But he had become doubtful and wary about these advices from experts. After all, he lost money after attending courses taught by experts.

"I can only say this, the market changes from time to time, but Investing Principles never change. Buy good to exceptional businesses at sensible price. Repeat until rich." The old man said in a firm, steady and assuring tone.

Sean paused and visualized how he will from now on choose good to exceptional businesses and keep buying them at a sensible price. But what exactly constitute a good business? And what did the old man mean when he say 'sensible price'? He needed to know these answers as they seem to be the hope for him to recover his losses. Sean suddenly remembered the amount of losses he had already made and felt the sense of hope drifting away.

He sighed, "Sir, it is no use. Like what you mentioned. I have infringed investment rule #1 and I broken this rule really badly. There is no hope for me now..."

COMPOUND

"Do you fish?" The old man asked.

"Well... yes I do. I used to fish when I was studying." Sean replied. "Why do you ask?"

"If I suggest a fishing competition between us, are you game?" The old man challenged Sean.

"Well, I wouldn't mind, although I am not really in the mood to do so."

"And what if I add a wager to it? Whoever catches the first fish first wins. And the loser will have to pay the winner a hefty sum of..... 1 cent! Will you be able to afford to do so?" The old man questioned.

"1 cents as wager? Well, I can definitely afford 1 cent, but that wouldn't be much fun, would it?"

"Not fun? You are right. So whoever catches the first fish wins 1 cent. And to make it much exciting, after paying out that 1 cent, we move on to round 2 but let's double the wager for round 2 so that the person who catches the fish first that round gets 2 cents instead of 1 cent, will you still be able to afford it?" The old man asked.

"Come on sir, 2 cents? Yes, I can afford it. But still doesn't excite me really..."

"And what if we continue to double the wager and play for 30 rounds? Will you still be able to afford it?" the old man asked, looking innocently serious, as if he was serious about the wager."

"30 rounds? It is probably a few dollars of wager. I guess I can afford it."

"Really? I didn't know you were that rich." The old man grinned as he sipped some coke from his coke can. "Well then, let's FISH!"

"Huh? Now? I don't really have a fishing rod with me and I..." Sean was obviously not prepared.

"Nay! We are not really going to fish physically. Let's fish mentally instead. Do you know multiplication? If you want to be an investor, you better know some simple maths like addition, subtraction, multiplication and division."

"Simple maths? Don't you need more than that?"

"If anything more than simple maths is needed for investing, today I will probably be distributing newspapers instead of investing." The old man laughed.

If anything more than simple maths is needed for investing, today I will probably be distributing newspapers instead of investing

"Now Sonny, back to our fishing game. You say that you can afford to bet for 30 rounds, I want to confirm that you can really afford before betting with you. That is assuming that you lose some of the rounds and have to pay me. What is the wager for round 3 sonny?"

"Well, Round 1 will be 1 cent, Round 2 will be 2 cents and round 3 is 4 cents."

"Good, I assume that you can still afford 4 cents. What if you lose in Round 10, what do you need to pay me?"

Sean began the calculation on his notebook.

Round 1	1 Cent
Round 2	2 Cents
Round 3	4 Cents
Round 4	8 Cents
Round 5	16 Cents
Round 6	32 Cents
Round 7	64 cents

Round 8	\$1.28
Round 9	\$2.56
Round 10	\$5.12

"Well, that is \$5.12 for you, sir. And don't worry, I can still afford it." Sean replied confidently.

"Oh really? But can you afford to lose Round 30?"

"I don't think I will have any issues with that" Sean answered casually.

"Then would you mind confirming you can afford Round 20's wager before we start the game."

"Sure," Sean continued to calculate on his note pad from where he left...

Round 10	\$5.12
Round 11	\$10.24
Round 12	\$20.48

Round 13	\$40.96
Round 14	\$81.92
Round 15	\$163.84

The old man smiled and asked innocently, "Hundreds?! Wow! I wonder what the wager for Round 20 will be?"

Sean continued to calculate...

Round 16	\$327.68
Round 17	\$655.36
Round 18	\$1,310.72
Round 19	\$2,621.44
Round 20	\$5,242.88

[&]quot;Wow! We are in the hundreds at Round 15?!" Sean exclaimed.

[&]quot;\$5,242.88!?" Sean gasped.

"It is only Round 20, sonny. And somebody was mentioning he could afford Round 30..."

Sean smiled sheepishly and continued his calculation. He was interested to find out the final figure.

Round 21	\$10,485.76
Round 22	\$20,971.52
Round 23	\$41,943.04
Round 24	\$83,886.08
Round 25	\$167,772.20
Round 26	\$335,544.30
Round 27	\$671,088.60
Round 28	\$1,342,177
Round 29	\$2,684,355
Round 30	\$5,368,709!!!

"\$5 MILLION!!! What just happened?! A while ago, we were talking about a few cents then a few dollars. How did we go into the millions? What have I gotten myself into?" Sean was shocked.

"Sonny, what you have gotten yourself into, is a way to become seriously rich,

IF, you learn how to invest and double your money. This is also known as the
power of compounding. And when I found out the power of compounding
about 60 years ago, my life changed dramatically."

Sean was still shocked at what he saw. How can a wager of 1 cent turn into \$5 million? He had heard of and understood compounding, but the feeling was different when he experienced it through a mental simulation. His state of shock turned into hope, "And that means if I learn how to invest and compound my money, I can easily recover my losses as well as potentially become very rich."

"Yes sonny, you WILL become very rich. Like myself, I had never doubted that I was going to become as rich as I am today."

Somehow, what the old man said seem to settle peacefully into Sean's heart.

"Are you ready to learn more on how to buy businesses and compound your money?" The old man asked in an offering manner.

Sean felt the warmth and kindness for this old man. "Are you are willing to teach me?"

"That is, if you are willing to learn and apply what you learn." The old man smiled.

"I see that I have a lot to learn and I want to thank you so much for being willing to teach me." Sean looked relief and hopeful for awhile, but his mind started to drift off to his friends whom he had lost money for, and began to frown.

"Why that frown?" The old man mirrored Sean's expression.

"Well Sir, the thing is that I have not told my friends or my wife the amount of money that I have lost. And even though I learn how compounding can help me, it will still take time. And between now and then, I still do not know how to face them."

The old man gently, yet firmly, placed his hands onto Sean's shoulder and said, "Sonny, you have to go and tell them the whole truth. You see, your friends and your wife love and trust you, and that is why they put their money with you. If you want to continue to be loved and trusted, you have to lovable and trustworthy. And even though investment rule #1 is to never lose money, what is more important is that you don't lose an ounce of reputation and integrity, not 1 single ounce. You can always make money back, but once you lose trust, it will take a much longer time and effort to earn back then money."

Don't lose an ounce of reputation and integrity, not one single ounce. You can always make money back, but once you lose trust, it will take a much longer time and effort to earn back then money

Sean sighed and said, "You are right Sir, I will have to tell my friends the truth. I wonder what they are going to say, and I am honestly scared. But I want to be someone they can trust to be honest."

"That's the spirit boy. When one of my managers lost \$500 million, he knew he had breached investment rule #1, but what I told him is that everyone makes mistakes and what is most important is that he acknowledge the mistake and learn from it. If you try to hide, it is never going to be helpful in anyways." The old man reassured Sean.

Sean thanked the old man for his advice and decided to give his friends a call that very day to explain the situation. The old man also arranged for Sean to meet him again at the jetty to continue their coaching regarding the investing.

Part 3: Great Businesses

BUYING BUSINESSES

After parting with the old man the day before, Sean called his friends out for dinner and told them what had happened. He was surprised when his friends gave him the assurance that they were not in anyways angry with him. They even mentioned that when they put their money with Sean, they were grateful that a friend was willing to help them make money. And even though Sean had lost the bulk of their money, they felt responsible as well. In fact, one of them even apologized and felt bad that Sean had to carry the burden of the losses with him. Sean was relief and shared with them his encounter with the old man. He shared what the old man had taught him about looking at stocks as businesses and the power of compounding. His friends were intrigued and told Sean to keep them updated with the lessons he was going to receive. At night, he also told his wife about the losses. His wife was shocked that Sean had lost so much money but was even more shocked that he had not shared it with her earlier. He asked for forgiveness and his wife lovingly hugged him and said, "I am confident that all will be fine. I am confident of your ability and I know that God is blessing our family". Sean felt the burden and worries, like heavy chains that have been chained around him for months, broke and fell to the ground. That night, he slept peacefully like a baby.

The next day, he was excited to meet up with the old man to share the good news. When he reached the jetty, the old man was already there fishing and munching on a burger. Besides him was a can of coke. Sean greeted him

warmly and the old man looked please to see him. Sean then excitedly shared his story. The old man applauded him for taking action.

"Now have you brought what I told you to?" The old man asked. Before parting the day before, the old man had asked Sean to bring along all his past trades. Sean printed out his trades from his brokerage account and gathered them neatly in a file. He also had a journal where he kept records and his analysis of his trades so that he could learn from them. This was taught to him when he attended the trading courses. He handed the file and the journal over to the old man and sat down beside him.

"Ah, a journal. I see that you have one good habit that an investor should have." The old man commented. Sean smiled as the old man continued, "Let me take a look at your transactions. Hmm..." He opened the file and flipped through the pages. He stopped and pointed at one of the most recent transaction, "Why did you buy this?"

Sean took the journal back from the old man and pulled it open. He then stopped at the page where he recorded that particular transaction the old man was asking. "Well, for that trade itself, I bought it when the price broke its 1 year high after 2 weeks of consolidation." The old man raised his eyebrows, "And so, WHY did you buy it?"

Sean thought he had already answered that question. But since the old man asked again, he decided to repeat it, slower this time, "This stock's price has been moving sideways for 2 weeks. And when it started moving upwards and making a new high, I went in and buy it. Based on the other indicators, it should go up by at least another 10%."

The old man listened attentively and pondered, "Sonny, let me ask you in another way, what are you buying, when you pay for this stock at the price you bought it? What business is this stock in? How much has this business been making for the past years?"

Sean was speechless. In fact he was clueless what the old man was asking him. He thought hard about what the old man was asking and after some thinking, he attempted a reply, "If I am not wrong, this stock is a logistic company. I do not know how much it has been earning. What I was taught in the courses was that the fundamentals of the business are reflected in the stock price already, thus I do not need to bother about it. So I buy this stock because its price is moving upwards. And what I am buying is the possibility of it rising about 10% so that I can make a profit."

The old man grinned. He slowly sipped from his can of coke and then posed a question, "Sonny, let me ask you this. Have you ever bought a car because the price is going up and you do not even know what the specifications of the car are and what it looks like?" Sean shook his head. "What about a house? Or

even a laptop? Or even clothes?" The old man asked. Sean continued to shake his head.

"Then why do you do that when it comes to stocks?" The old man asked. Sean just shrugged his shoulders. He felt as if he was a grandchild being reprimanded by a grandfather. It was gentle yet firm.

Seeing Sean looking rather lost, the old man chuckled. "Haha sonny. You have to look at stocks as small pieces of business. Because that is what they are. It does not make sense to buy the business without even know what the business is about and how the business has been performing. If I have a business and I offer to sell it to you at \$100,000, will you buy it from me without even knowing what business it is and how it has been performing? Will you buy it if I tell you that the price of this business has been stagnant but has just rise and will continue to rise?"

Look at stocks as small pieces of business.

Sean shook his head. "No, I will not do that."

"Of course you will not! At least you will not from today onwards. From now onwards, you should look at stocks as businesses. Is that clear?" The old man asked with a stern look and a commanding tone. Sean nodded vigorously. The

old man smiled, reached into his bag, pulled out a can of coke and handed over to Sean. Sean smiled back while receiving the can of soft drink from the old man.

The old man commented, "I bought this can of coke from the discount store at 50 cents."

Sean chirped in "And for 50 cents, you are buying 330ml of Carbonated Water, High Fructose Corn Syrup, Caramel Color, Phosphoric Acid, Natural Colors and Caffeine."

The old man slammed his laps laughed heartily, "Ho ho, you learned well Sonny! But more important, I am buying myself 330ml of satisfaction."

Both of them laughed as they cheered with their cans, celebrating the first lesson Sean had learnt. Stocks are Businesses.

THE RIGHT BUSINESSES

As they drank, they began to talk about their lives. The old man shared about how he got started investing into his first share at the age of 11. Before that, at an even younger age, the old man had worked hard selling coke to tourists, started his own pin ball business and did many things to make money. That was the way he started accumulate money.

"But up till the time I met Professor Ben, I did not have a methodology on how to pick stocks. When I read his book, it was as if his words were a combination code to a safe filled with 'secrets'. He opened up a whole new world for me, a world that I have been searching for."

Sean cried out, "Your Professor taught you to buy businesses? My Professor told me not to even try?!"

The old man laughed, "Sonny, the school rewards complex behaviours. So, many of the Professors are trained to teach you things that you will likely not be able to use. I think it is really kind of your Professor to give you warning. And well, Professor Ben was a different kind of Professor. He walked the talk and was one of the greatest investor and businessman of his time. It fact, he was the father of Value Investing, which is the methodology we use to buy businesses. But not just any kinds of businesses, Value Investors only buy those we know are going to make us rich."

Sean felt his curiosity growing. Something in him was hungry to know more. "And what kind of businesses do Value Investors buy?"

The old man turned and smiled for a moment, and then his expression changed to a serious one. He wanted Sean to take note of what he was about to explain. Sean caught the message and responded by sitting up straight, ready to absorb and learn.

"When we started, we bought <u>undervalued</u> businesses. These businesses are those that are selling below their book value. And honestly back then, we were not concerned about the nature of the business. What we were interested in was to buy \$1 for 50 cents. If the business had a book value of \$100 million on its balance sheet, and it was selling at only \$50 million, we will go in and buy as much as we can. During that time, I bought Western Insurance, Geiko, Rockwood and Company, Philadelphia and Reading Coal & Iron Company. Boy, Mr Market was offering them at a discount; I just got to have them.

One classic example was when I bought Union Street Railway in 1953. Union Street operated a bus service near New Bedford, an area containing about 120,000 people and owned 113 buses in total. What enticed me was this: It had current assets of cash and U.S. government securities totalling \$969,363, or \$52.79 per share. And for non-current assets, it had "Special Deposits" and "Accid. Ins. Trust", which were \$386,376 and \$600,000 respectively, or \$53.72 per share. Adding it all up, you had \$106.50 per share in cash and cash-type items with no debts.

And guess what Mr Market was offering for its shares? \$30 per share. Wouldn't you buy it?

This method lasted me up to the early 1960s and made me millions. But times began to change and we began look at businesses differently. I adopted the 'Fisher' philosophy and went fishing for businesses with good to superb underlying economics, buying them at a sensible price. With the old method of buying undervalued businesses, we made millions, but with the new method, we made... Billions."

The word 'Billions', echoed in Sean's ears. He began to wonder who this old man is and why did he have such an obsession with money. And the most important question was how he could achieve similar results as well. But before he could utter a word or ask any questions, the old man handed him a fishing rod.

Author's Note:

Book Value of A Company

Benjamin Graham explained that a business' Book Value was similar to that of a person's Net worth.

For example, if a person owns \$10,000 in the bank, a house that is worth \$100,000 and at the same time, she has a bank mortgage loan of \$60,000. What will her Net worth be?

The way to calculate Net worth will be to imagine her selling off all her assets and paying up all her loans. Whatever that is left, will be her net worth.

So in this case, selling off the house and paying back the mortgage will give this person \$100,000 - \$60,000 = \$40,000.

And do remember that she has \$10,000 in the bank. So her net worth is \$40,000 + \$10,000 = \$50,000.

When you want to find the book value if a company, you can simply take all the assets (including cash) deducted by the liabilities. And unlike Warren, we may not have the money to buy an entire business, thus we can look at Book Value per Share. This is the Book Value of the business divided by the number of Outstanding Shares.

So the concept of buying undervalued businesses is simply buying a business when the share price is below the book value per share. Just imagine that you can buy the person's Networth of \$50,000 over for only \$25,000, isn't it value for money?

The tricky part is being able to accurately analyse and determine assets' value. That is the result why the intrinsic value of the stock is usually an estimate and Value Investors will factor in room for error, known as a Margin of Safety.

Value Investing has moved on from this method. So while Value Investors continue to look at stocks as businesses, the book value is not the only deciding factor. Read on to find out what types of business should we buy as value investors.

COMPETITION

"Let's have a little fishing competition. We will fish for 1 hour, and at the end, whoever catches more fish, wins." The old man challenged. Sean was game for it. He took the fishing rod over from the old man. He loved competitions and could not resist one.

The old man then causally added, "The catch is this. For every 1 fish you catch more than me, I will give you \$1,000." As the old man said this, he took out a thick wallet and waved it at Sean. "What?! \$1,000?" Sean exclaimed.

"Yes sonny, \$1,000 for every 1 fish you catch more than me. So if you catch 10 fish and I only catch 8, I will give you \$2,000." Sean was really excited now.

"Hey wait a minute, and what if you catch more fish than me? What do I pay you?" He became a bit more cautious. After all, Sean remembered that the old man was quite a good fisherman.

"This is a wise question. Most people jump into the venture after seeing the possible gains and they don't even bother to think about what are the possible losses." The old man commented. "For every 1 fish I catch more than you, you shall treat me to a burger and a can of coke."

"Cool. This sounds good, Sir." Sean was ready to get started.

"I see that you are game for this. You can begin anytime and use the baits that I have prepared. This competition will end 1 hour from now." The old man said while handing Sean a bucket of bait.

Sean felt hopeful. He used to fish leisurely while he was studying and was familiar with fishing ground in this area. After observing around, he chose a spot some distance away from the old man and prepared his bait. He then quickly tossed the line into the sea. He remained focused and after a while, felt a tug on his rod. His heart raced as his fight with the fish began. While tugging carefully, he checked his watch, "5 min had past. I gotten get this fellow into my bucket" and with a final full, he successfully pulled a beautiful cat fish out of the sea. "Yes!" He exclaimed with joy as he quickly yet carefully placed this \$1,000 creature into the bucket provided for him. "That took me 7min, I have got 53min left" Sean took a quick glance at his watch.

Sean was glad bit he had no time to pause and celebrate. Every fish is worth \$1,000 to him and he wanted to win as much money as he can. Thoughts of him bringing money back to his wife and friends filled his mind and he felt the joy when he imagined their happy faces. That raised his determination even more and he focused harder to 'feel' his next catch.

Within another 10 min, Sean caught the 2nd fish. "Alright!" He turned to sneak a quick look at how the old man was doing. It had been rather silent at the old man's side and he appeared to be very relaxed and confident. From where he sat, Sean stretched his neck and tried peeking into the old man's bucket. It looked empty. Sean was \$2,000 ahead and he had another 40min to go. It seemed fishy that the old man was able to be so calm being \$2,000 down in the competition. Sean wondered if a few thousand dollars really meant so little to this rich old man. 'After all, he made billions.' Sean then quickly regained focus to continue to fish for another thousand dollars. He could not afford to waste any time.

50 minutes had past and the score was 4 for Sean and 2 for the old man. Sean was glad that he was potentially going to be \$2,000 richer at the end of the competition. 'Let's go for \$3,000, I still have time', Sean pushed on.

At the 57min mark, Sean did catch another fish, pulling the lead to 5:2. He was now \$3,000 ahead in the game. While he was releasing the catch into the bucket and celebrating internally, he glanced over and saw that the old man had put his rod down and was walking towards across the jetty from where he had been fishing. He then squatted and looked down into the sea in a dejected manner.

"Come on Sir, are you giving up already?" Sean asked sincerely. He suddenly felt bad for eagerly wanting to win money from this nice old man. After all, \$3,000 was not a small sum for a fishing bet. He felt a dilemma. Should he

reject the winnings when the old man offers it to him later? Or should he just accept it? After all, he needed the money to make his losses back. Thoughts were randomly appearing in his mind as he continued looking at the old man who had lost the battle.

Sean could not believe what he saw next. The old man bent and reached down from where he was. He then pulled up a fishing net full of fishes. It was apparent, that the net had been planted there much earlier with traps, trapping the fish. Sean's jaw dropped as he watched the old man 'unscrupulously' dragged the net onto the jetty and started throwing the fishes into the bucket. "Haha! Just in time! 1 hour is up! The competition is over, sonny. I wonder who won?" the old man laughed.

The question was a rhetorical one as the result was obvious. Sean still couldn't believe that he had for a moment felt pity for this cunning old man. His shock from the old man's action dissolved as his anger grew. "How could you use a fishing net while I was using a rod? There was no way I was going to win. You set me up. It was all planned. You had placed the net there much earlier and then you tricked me into this competition. It is just not fair! The results of this competition must be void." Sean fired.

The old man was cool about Sean's reaction. It was as if he knew that was coming. "Come on and sit beside me Sonny. And tell me what you have learnt."

ADVANTAGE

Seeing the old man's calmness, Sean simmered down. He felt that the old man sincerely wanted him to learn something, so he sat down and began to ponder. "I... I don't really understand. There was no way I was going to win from the on start. It is not fair. You had a clear advantage to begin with."

"You asked me earlier, what kind of businesses Value Investors buy. The answer is that we buy the sure winners and avoid the rest." The old man paused and look at Sean's confused face. He then continued, "If the fishing competition we just had represents the world of business and both of us were businesses, who will you buy? And why?"

Sean replied, "I will buy 'You' since you were sure to win." The old man continued to probe, "And what was it about me as a business that made you so sure I was going to win?"

"You had a fishing net while I was using a rod. It was a clear advantage that you had. If I knew it from the on start, I would not even agree to the competition. And by the way, I still think the results should be void." Sean answered.

The old man nodded to acknowledge what Sean had said, "Sonny, in the business world, the clear advantage you mentioned is known as a competitive

advantage, or you call it an economic moat. And you are right, we will only buy businesses with durable competitive advantages, because they will win and will continue to win with that advantage they have over their rivals. And their rivals, like you will continue to claim that such advantage isn't fair and that these businesses are illegal. They will also continue to shout foul and complain that these businesses are monopolies and are behaving against the Fair Competition Act. Can you relate to that?" Sean smiled sheepishly and nodded.

"Well, the key is to always and only buy businesses with durable competitive advantage. That way, you will know that you are going to win. The issue is that these advantages are not that obvious. It is usually not written on the balance sheet as assets in most cases, and thus you have to look beyond the surface to discover them. They are like hidden 'fishing nets'," grinned the old man.

Sean reacted by rolling his eyes playfully in a disgusted manner. He then asked, "So how do we identify if a business has a durable competitive advantage?"

DISCIPLINE

The old man ignored the question, "I guess you owe me at least a month's supply of coke and burger." Sean sneered, "You are one sly old man, Sir."

"You can call me 'sly', but I only bet when the odds are for me. And from now on, if you want to be a successful investor, you should do that as well even if the bet is only \$2."

"Do we have to be that serious about things?" Sean was doubtful.

"I do not preach what I do not do. In fact, I rejected a \$2 golf bet because the odds are against me. I have to admit that the odds are usually against me on the golf course," chucked the old man. "Sonny, remember this, if you let yourself be undisciplined on the small things, you will probably be undisciplined on the large things as well."

If you let yourself be undisciplined on the small things, You will probably be undisciplined on the large things as well. Sean was impressed with what the old man had shared. He reflected on himself and found it is true that his habits, his poor discipline and his lack of focus surfaced in both the small things as well as the big things. As the saying goes, "How you do anything is how you do everything." Sean mentally noted to be cautious of his small little patterns in life before the cracks in the bigger areas start to show.

The old man gave Sean time to internalize the lesson. When he saw that Sean had absorbed the lesson, he spoke, "Are you ready to learn how to find out if a business has a competitive advantage?" Sean nodded.

"Good! Follow me." The old man had been packing his things all along. He picked up his belongings and started walking off. He was so smooth and so efficient; it seemed that everything was happening according to his plans.

Sean stood and caught up with him. "Where are we going, Sir?"

"To my car, sonny. I am bringing you somewhere." The old man replied sharply.

As they reached the car park, Sean began to wonder what car the old man was driving. A BMW, an Audi, or probably a Mercedes? He scanned around and saw a number of luxurious cars. After all, it was a weekday and most people who

could not afford these cars, could not afford to be fishing at this time. But when the old man stopped at an old sedan car, Sean tried hard to not look disappointed.

"Were you expecting a Mercedes, sonny?" The old man asked, smiling. It was as if he had been questioned about his car vis-a-vis his financial status many times before, it became a norm for people to be surprised with the car he drove.

"It is nice to drive a big luxurious car, but to pay a \$100,000 for a car, means that I am missing the opportunity to invest it. A \$100,000 at 20% for 20 years is about \$3.8 million and that is just too much to spend on a car, isn't it?"

Sean concurred with a nod while getting into the car. Investing is not just a skill, it is a lifestyle. He asked again, "Where are we were going?"

"To the Battlefield." The old man replied as they drove off.

BATTLEFIELD

"This is the Battelfield?" Sean asked as they step out of the old man's car and walked towards a huge shopping mall. "To be honest, I was expecting the stock exchange or something."

"I do not shop for businesses at Wall Street. I get them from Main Street." The old man replied to Sean's comment. "And Main Street is where the battle takes place. Wall Street is merely where commentaries are made blockheads. Anyway, we are here to merely to remind ourselves what we probably already know about these businesses."

The old man scanned around the shops in the shopping mall. "Are you familiar with any of these shops? Do you know what business they are into?"

"I am familiar with most of them. These are common brand names, aren't they?" Sean remarked. The old man nodded. "Good, that is why we are here. Let's continue our analysis over a cup of coffee." They walked to a Starbucks café, ordered some coffee and sat down.

"From where we are sitting, we can see a number of shops. Write the names of these shops down and beside the names, write down what kind of products or services are they providing." The old man instructed. Sean did as he was told and started writing.

- 1. Digital Image Develop Photos, printing
- 2. KFC Fast food, fried chicken
- 3. Starbucks Coffee
- 4. Citibank Banking Services
- 5. Harris Bookstore Books and Stationeries
- 6. Kiddy Palace Children's toys, apparels, necessities
- 7. AA Medical Group Health care
- 8. GNC Supplements
- 9. Breadtalk –Bread and pastries
- 10. Nike Sports apparels

The old man previewed the list and signalled for Sean to stop when he reached 10 items. "That should be enough to get us started." Sean stopped and looked up, waiting for the next set of orders.

The old man continued, "Which of these businesses, do you think have fishing nets instead of merely rods?" Sean looked at the list and frowned. He wondered which of these businesses had a durable competitive advantage. All

of these seemed like good businesses, but at the same time, they do have strong competitors. Sean was unsure which businesses had any advantage.

Seeing Sean having difficulty, the old man hinted, "Businesses with fishing nets are able to draw customers to them and back to them over and over again. When you want that particular product or service, you will go to them instead of others. These businesses are able to monopolize the market through their unique services and product. Ask yourself these questions when we are analysing whether a business has a competitive advantage:

1. What is the value (products/ services) this business is providing?

You have already identified these. In the event you are not able to answer to this question, you should not even consider buying this business. We will stick to our circle of competence.

2. Is this value provided by anyone else?

If the answer is 'No', we have found a business that has monopolized the industry. And if the answer is 'Yes', we move on to question 3.

3. Will I choose to get this value from elsewhere instead of this business?

If you will choose to get it elsewhere, this business may not have the competitive advantage we are looking for. Perhaps the 'elsewhere' you want to get the value from may have the competitive advantage we are looking for.

This is especially so, if the 'elsewhere' is the name that comes to mind when we think about that particular value we want.

And if you rather choose to get the value from the business we are looking, we should ask ourselves question 4.

4. Why would we rather get this value from this business instead from anywhere else?

We want to be able to write down the reasons. These reasons are likely the competitive advantages this business has. And finally, we will move on to the fifth question.

5. Is the reason(s) we identified in question 4, sustainable in the long run.

We are looking for a durable competitive advantage, not just a temporal one. This is because we want a business that can continue to employ such an advantage over and over again for many years.

Did you get the 5 questions?"

Sean was furiously noting down the 5 questions, the reasons and explanations. He had trained himself well since Business School days to be able to copy notes. When he completed, he looked at the messy handwriting on the notes and made sure he could understand what he was writing. After all that scribbling, that page on the journal looked like graffiti instead of business notes. But he was satisfied as he read through once and found himself being

able to interpret the mess. He looked up and saw that the old man was waiting

for him to continue. The old man took that as an indicator to move on.

"Now sonny, let's try these 5 questions with the list you have and we will mark

out those businesses which we suspect, have durable competitive advantage.

For those which you are not sure, I would suggest you either leave them aside,

or probe further by finding out more about them.

Sean looked at the first business on the list; it was 'Digital Printing', a photo

development shop with printing services. He began running it through the 5

questions:

1. What is the value (products/ services) this business is providing?

Ans: Developing Photos and printing services.

2. Is this value provided by anyone else?

Ans: Yes. In fact, there were other similar shops around.

3. Will I choose to get this value from elsewhere instead of this business?

Ans: It does not matter.

At this juncture, Sean looked up and asked the old man. "If it does not matter

where I choose to get this value from, does it mean in that entire industry,

there isn't a business with competitive advantage?"

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"Very good thinking, sonny. This may mean a few things. If it doesn't matter to

you where you get this value from, it is either you do not understand the

business enough or it may mean that it is in a Price Competitive Industry.

Either way, you should avoid this business. Just to share a little more about

Price Competitive businesses. There are some industries where it is difficult for

businesses to build up a competitive advantage. In these businesses, 'Price'

may be the only factor customers look at when making their buying decision.

We want to avoid these industries. But sometimes, there are businesses that

can consistently offer a lower price to their customers because they have some

durable competitive advantage. These businesses surface well when you go

through the 5 questions. The key point is to use these 5 questions to find out

businesses you strongly suspect the existence of a durable competitive

advantage."

"I see. I should only invest in businesses which I strongly believe that there is a

durable competitive advantage. I will continue with the rest on the list and see

how it goes. " Sean replied and continued this mini exercise. The next business

was KFC or Kentucky Fried Chicken.

1. What is the value (products/ services) this business is providing?

Ans: Fastfood, Fried Chicken

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2. Is this value provided by anyone else?

Ans: Of course. There is plenty of fast food restaurants around and there are many shops selling fried chicken.

3. Will I choose to get this value from elsewhere instead of this business?

Ans: Hmm. That depends. There are times when I really do crave for the Finger Licking Good chicken. So if it is fast food, I can get from other places, but if it is fried chicken, I will want a KFC.

4. Why would we rather get this value from this business instead from anywhere else?

Ans: Because it has a secret recipe that made the chicken taste great. It has a unique aroma.

5. Is the reason(s) we identified in question 4, sustainable in the long run.

Ans: Since it is a secret recipe and KFC is an established brand, it should be sustainable.

Sean looked up at the old man. He still wasn't sure if KFC had a durable competitive advantage. The old man looked back and asked, "Will you want to own a business like KFC? Do you suspect that it has a durable competitive advantage in business?"

"Well, it seems so. But I am not sure." Sean replied.

"That's good. What we want at this stage is to find business we suspect may have a durable competitive advantage. We will confirm it later by looking at its track records. But why I want you to do this even before we look at the numbers is to make sure you only invest in businesses you can understand. This will help a lot especially in changing times like this. Some people dive in to look at numbers and become so absorbed in the statistics. They ended up buying businesses which they cannot explain what the natures of those businesses are or if the businesses have any durable competitive advantage. You want to be able to explain to yourself why you want to buy this business. And you want to be able to understand the business so that you know if it is still relevant in the long run. In this case, if you suspect KFC to have a durable competitive advantage, we will shortlist it and find out for ourselves using the numbers." The old man explained.

"Oh, I see your point. I do suspect that KFC has a durable competitive advantage since it has a secret chicken recipe, or rather; they have their customers thinking that their chicken is special. Looking at it this way, I would consider buying KFC as a business since I think it should be able to make money in both the short and long run." Sean remarked.

Sean was beginning to connect the dots: the idea of looking at stocks as businesses and the way to sift out winners from the rest. For the first time in his life, he began to look at 'shopping' in a different light. He is becoming a Value Investor, shopping for stocks in Main Street instead of Wall Street.

MONEY IN, MONEY OUT

The old man also suggested a few areas Sean could potentially start asking questions about the businesses. "You should find out where has your money been going and where did it come from. Ask yourself:

Where do I have to spend money every month?

Answers could be food, groceries and petrol. You should brain storm around these areas. These are industries that have consistent customers because.

Where do I love to spend money on?

This will be an area where you have certain amount of passion in. And it is likely that with passion, comes greater understanding of the business. Is it fishing? Is it cars? Or it is food again? Or could it be education?

Where do I earn my money from?

Your job! What industry are you working in? Since you spend a whole lot of time at work, you will likely be more familiar with your industry than any other.

Author's Note:

Circle of Competence

Quoting from Buffett's 1996 Letter to Berkshire Hathaway Shareholders,

"Should you choose, however, to construct your own portfolio, there are a few thoughts worth remembering. Intelligent investing is not complex, though that is far from saying that it is easy. What an investor needs is the ability to correctly evaluate selected businesses. Note that word "selected": You don't have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital."

You may find it to be overly emphasized, but I would like to drill it into you that as an investor, we are buying businesses. As such, it is important to buy what we understand. As suggested by the old man, since you spend money or earn money from a business, you *may* have some amount of idea on how it works. These are suggestions to what may be in your Circle of Competence.

Buffett had been known to avoid businesses outside his circle of competences and he said that

"If we can't find things within our circle of competence, we don't expand the circle. We'll wait."

By this, it is not to say that we should not learn and find out more about businesses we do not understand. It is rather a warning not to rush into businesses we do not understand just because those that we do, are not selling at a sensible price.
Finding Businesses in Your Circle of Competence
Let's start finding some businesses which you have some understanding in. Go through these questions:
List down some names of businesses you earn your money from. (It can be either your company or your company's clients as well.)
List down some names of businesses you spend your money with (If you have been keeping track of your credit card bills or your bank giro, pull them out and see where your money has been going to month after month. These businesses have at least one loyal customer – YOU!)

Now you have a list of possible businesses you may want to buy. Put them through the 5 question check list to see if you suspect they have a durable competitive advantage.

The 5 Question Check List

- 1. What is the value (products/ services) this business is providing?
- 2. Is this value provided by anyone else?
- 3. Will I choose to get this value from elsewhere instead of this business?
- 4. Why would we rather get this value from this business instead from anywhere else?
- 5. Is the reason(s) we identified in question 4, sustainable in the long run.

After putting the businesses on your list through the checklist, you should be able to write down what you think the durable competitive advantages of these businesses are.

Just give it a try even though you may not be sure. In the next chapters, you will be introduced to 5 possible types of durable competitive advantages and that is when you may be able to label it with more certainty. And if you are really unsure about the business, you can either read up more about it through its annual reports, or for now, throw it back into the sea.

BUSINESS TO BUSINESS (B2B)

"After you have brainstormed through these questions, you may want to think a little deeper regarding the needs of these businesses you have identified. Like individuals who have needs on a daily to monthly basis, businesses have needs as well. Can you think of some needs which businesses have?" The old man asked.

"Let me see. I think advertising is one of them." Sean spoke the first thing that came to his mind.

"Advertising is a great business. Most of the businesses need it, making it a strong, stable and in fact growing industry. And are you able to identify the winners in the advertising industry?"

"Well, based on observations, it should be the local newspapers by Singapore Press Holdings and the TV media by Media Corp."

"Good. List them down as well. We will want to look at businesses that provide value to businesses. These may not be so apparent when we look at our personal daily needs. Most of us won't spend our money advertising for ourselves except for morbid occasions when we lost our pets or loved ones. Thus advertising businesses or business to business (B2B) businesses may not appear. Yet it is great business to provide value to businesses as compared to individuals."

Sean saw the light. "Oh yes. It is something to close a deal on a customer, but it is another ball game to clinch a business deal with other businesses. Let me think of what other needs businesses may have and who are the likely winners.

Telecommunication - There are only three providers, I guess I can list all of them down.

Transportation and courier services - How about Singpost, DHL, Fedex?"

Sean continued short listing businesses that may have durable competitive advantages. The day ended with Sean having a long list, a drained brain and a fruitful day. He was one step closer to becoming a Value Investor.

Author's Note

Warren Buffett likes to explain durable competitive advantage using the analogy of a Moat around the castle.

Imagine a business to be like a castle. For the castle to survive attackes, it needs to have a moat around it. The deeper and wider the moat, the less vulnerable the castle would be when it is attacked.

A castle with a moat is akin to a business with durable competitive advantage. With such an advantage, a business is able to consistently draw and retain customers. This allows the business to make exceptional profits when times are good and continue to do so and survive even when times are bad. Businesses without an Economic Moat will find themselves struggling during poor economic times and will not survive. Thus when the economy improves, businesses with Economic Moat found that their rivals have been wiped out, leaving them to enjoy great profits as an abundance of customers now having the money to pay the industry.

Types of Durable Competitive Advantage/ Economic Moat

In literature, there are 5 ways for a company to build a competitive advantage. Using these 5 as a guide may help you identify businesses that may have such advantage. These 5 moats are:

- 1. Product differentiation
- 2. Branding
- 3. Low Costs/ Low Price Producer
- 4. High Switching Cost
- 5. Legal Barriers to Entry

Product Differentiation

There are businesses are there that are able to distinctively differentiate their products and services from their competitors. Even though they seem to compete in a particular industry, their products and services stand out differently.

An apparent example at the point of writing will be the iPhone. The iPhone is not just any other phone. Either you are using an iPhone, or you are using some other phones. The product itself is a phone and more.

Another example may be Kentucky Fried Chicken. When you want to eat Fried Chicken, KFC stands out as a unique brand and produces a unique aroma for the hungry customers.

The Complexity of a High Innovation Need Industry

We need to be able to identify if a business is able to protect its Product Differentiation through either branding, or legal means. Product Differentiation is usually a starting point, because in our high tech world, the uniqueness of a product is quickly modelled after by other businesses who want a piece of the pie.

And if we find the business that we are looking at buying, having to constantly innovate in order to survive, we got to beware that such a business may not have such a strong moat after all. What we want to look for are businesses with products and services that do not require too much research and development (R&D). This is not to say that it is not good for businesses to

invest into R&D, but we want to avoid businesses that requires R&D in order just to *survive!*.

Coming back to the example of the iPhone and KFC. Even though as I write, the iPhone is a unique and outstanding product at this point of time, we can note that the leaders in this industry had changed quickly and almost overnight due to newer, more innovative products. From my personal experience, the market leader used to be Nokia, and then the other phones came in and swarm the market with choices. For a while, the Blackberry seemed to lead but now it is the iPhone. And even though Blackberry and iPhone may have their niche market being loyal to them, most people will be ready to jump ship to try out another kind of phone when the current fad dies down.

(Do note that if you are reading this and you have no idea what iPhone and Blackberry are, this will not be surprising as times will change rapidly in industries that requires high innovation to survive.)

KFC on the other hand, requires little or no innovation to survive. Since the old of its founder, Colonel Sanders, the finger licking good recipe remained unchanged. From R&D, new product was introduced by the business, such as different flavoured chicken, cheesy fries, banditos, salad and many more. Some stayed due to popularity of the products, while some were taken off the shelf and forgotten. But these are add ons that help increase profits rather than determine the survivability of KFC. Most of its customers still come for the more than 100 year old finger licking good fried chicken. This is a more durable competitive advantage in terms of Product Innovation.

Branding

What brands come to mind when the following products are mentioned?

Soft Drinks

Diapers

Baby Care Products

Fastfood

Furniture

Newspapers

Well, these are areas where I spend my money and thus form my circle of competence. And it is common to find *most* people immediately thinking of either Coke or Pepsi when it comes to Soft Drinks, Pampers when Diapers is mentioned and Johnson and Johnson for baby care products. In fact pampers' branding is so strong that when we run out of diapers, we would sometimes say that we need to go and get more 'Pampers' instead of just diapers.

These businesses had sort of 'brainwashed' me into immediately associating the particular product to their Brands. The first brand most people will think of when they need a new piece of furniture would be IKEA. Note that I say MOST people, because there will always be some other people out there who may not flavour the above mentioned brands. But then, it is difficult not to think of these brands even though you may not prefer these brands. They have built their brands so strongly that they own a piece of your mind. Businesses with strong brands are likely to possess a durable competitive advantage.

Low Costs/ Low Price Producer

There are some businesses in the industry that are so huge and so efficient that they can undercut their competitors' pricing *consistently*. They possess what we call an economy of scale.

Because of their large numbers in either production or purchase, their cost of production is so much cheaper than their competitors and so they can comfortably lower their price to a level where it is not possible for their competitors to follow and still be profitable.

Imagine you would like to set up your own retail toy shop where you purchase toys from a supplier and sell them at a profit in your shop. A competitor of yours had been around in the market for years and has 50 retail shops all over the country. When both of you ask for supply of toys from the supplier, you bargain for as much of a discount as possible. Who do you think is likely to receive a bigger discount? You, or your competitor who is purchasing 50 times more toys than you? The answer is obvious. The supplier will give more discount to your competitor who is a bigger buyer which they cannot afford to offend or lose. Upon getting a bigger discount, your competitor can slash their prices to a point lower than yours, taking your business away.

You, on the other hand are in a fixed. Unless you can rapidly open up more stores or find more customers so that you can increase your order from the suppliers so much so that they will give you similar privilege as your competitors, otherwise, you cannot compete with them using price and have to think of ways to attract customers just to survive in the game.

Most small retail players who are not able to differentiate their products since it is the same products from the same suppliers, can only cross their fingers can hope to survive. Or they have to remain in their special location or provide special services to draw and retain customers. It will be a stiff neck competition for them, for they are faced with a business with a durable competitive advantage known as Economies of Scale.

The most apparent example when it comes to Economies of Scale would be NTUC Fairprice Supermarket in Singapore. They have huge networks and are all over Singapore. Because of this, they have Economies of Scale and are able to price things cheaper than their competitors. Unfortunately, it is not a listed company. In the US, Walmart will be the classic example.

High Switching Costs

I had an acquaintance, Dennis, who was an infamous Casanova. Every often, he would introduce his new girlfriend to us over lunch or dinner but within a few weeks, it will be a different lady again. He was so casual in his relationship with women that people would say that "he changes girlfriends as if he is changing clothes."

Dennis calls himself a 'party animal' and he was careful not to get into any commitment. Marriage to Dennis is taboo word and was the worst situation he can get himself into. To Dennis, as long as he is not married, he can continue to flirt and switch girlfriends as there was no string attached. But once anyone is married, to want to switch partners involves high costs both in terms of monetary, emotional and social.

In the business world, there are some products or services in which customers unknowingly married themselves to the business with a onetime purchase.

An example will be the Mircosoft Office software. As it seems today, almost all businesses are married to it once they use it. To change from Mircosoft office to another other office suite with all the desktop applications, servers and service will be costly in terms of re-training the users. On top of that, there will be worries of incompatibility in programs with other business partners, since most of the businesses are using Mircosoft Office.

But as the technology fastens its pace in today's world, people are able to learn faster and innovate to the point that switching costs may no longer be

such a huge problem for consumers. Not too long ago, it was rather painful to
switch phone brands as a customer needs to relearn how to use the new
phone. But today, this seems to be less of an issue and it is just part and
parcel of life.
Businesses, on the other hand may still incur high switching costs should they
choose to change service providers such as data management services, payroll
services, tax and accounting services, telecoms services. These may are more
apparent and relevant to business rather than individual consumers.

Legal Barriers to Entry

There are some businesses that have legal protection over their businesses. These may come in terms of legal contracts and government regulations.

In terms of government regulations, an obvious example is the Singapore Stock Exchange. Due to government regulations, there can only be one stock exchange and thus it works like a monopoly. Whenever you want to purchase or sell Singapore stocks, the transaction goes through the Singapore Stock Exchange and some money is left behind.

Legal protection such as patents and trade secrets can raise a barrier to entry for competitors. This is most apparent in the pharmaceutical industry where a business gets a patent for its drug. But do note that patents do expire and it will be legal to 'copy' such these invention after the patent expiration.

An example would be the Paracetamol. The first brand was Tylenol and it is still a very popular brand under Johnson and Johnson. But after the expiration of the patent, brands such as Panadol and Feverall have gotten part of the market share over the years. So while a patent can raise legal barriers to entry for competitors, it is up to the business to use that protection period to build its brand in order to continue the barriers to entry by being the market leader.

Wrapping up
We have gone through 5 different possible types of Economic Moat and again
the list is not exhaustive. Could you now identify which durable competitive advantage the businesses you have listed earlier may be having? Place them
into each of the category and at the same time, for each category; do see if
you can recognize any other possible businesses with that moat.
Product differentiation
2. Branding

3. Low Costs/ Low Price Producer
4. High Switching Cost

5. Legal Barriers to Entry

TRACK RECORD

The next day, Sean met old man at the jetty to carry on their lessons. "Here is your burger and coke, Sir!" Sean was in high spirits. The day before, he had shortlisted the businesses which he suspect had competitive advantages and he was excited to learn how to continue the analysis. This day, the old man had requested Sean to bring another 2 things, a laptop with internet connection and..... an old class photo. Sean had learnt to follow what the old man asked him to do, even if it seemed weird.

"Good morning sonny, thank you for the breakfast. I see that you are fresh and ready to learn." The old man received his breakfast and started munching. It was amazing how a person could eat the same food consecutively for a number of days.

"I see that you have brought your old class photo." The old man commented while continuing to munch on his burger. "Let me take a look." Sean handed the photo over and sat beside the old man. "Ah, there you are." The old man pointed at Sean in the photo. "You look as good as you are today." Sean smiled. The old man was an encouraging person and it was pleasant being with him.

"Sonny, before we move on to the next lesson, tell me what you have learnt so far." The old man requested. Sean placed his opened journal on his lap and look at the notes he had written. When he went back home the night before, he did a summary and was ready for such a question.

"I have learnt a lot, Sir. And I will just list down the points that I have learnt.

- Investment Rule 1 is to Never Lose Money and Investment Rule Number 2 is to never forget rule number 1.
- Risk comes from not knowing what we are doing.
- We are to look at stocks as small pieces of business... ..."

Sean went on and recapped all that he had learnt. The old man nodded with each statement he made and praised him when he finished. "Well done, sonny. You must have done really well in school! If I am your teacher, I will give you an A Star. And if you apply all that you learn with consistency and discipline, you will score an A Star result in your brokerage account too!" The old man's eye twinkled as he said that.

"Alright sonny, let's continue our lesson." The old man held Sean's old class photo up and asked, "I see that there are about 40 students in the class. I am going to make some general statements and you see if it is true." Sean gave a thumb up to indicate 'ok'.

The old man began, "In terms of academics, some of your classmates consistently did badly in class." Sean replied, "Yes..."

The old man made his next statement, "And some of them had mediocre performance while occasional great results." "Yeah, you are right." Sean replied.

The old man continued, "And sonny, there are some of your classmates who consistently did well in class." Sean nodded in acknowledgement, but he was visibly, not impressed. "Sir, what you have said is so general, it can be applied to anything."

The old man paid no attention to what Sean just said. He then asked, "Sonny, if I ask you to make a bet before the results are out, who the top students in your class will be during your final exams, will you be able to do so accurately?"

"It will be either this lady, Wendy or this guy, Harold." Sean pointed at the photo. "Really? Tell me more about what makes you so sure that they will be top?" The old man inquired.

"Wendy was an extreme! She had been topping the class for almost every single test in every single subject. She sat beside me during class and would not lend me her homework to (clear throat) copy. I still remember there was this particular history test. History was my worst subject and I had not been passing the tests. But when my paper was handed back to me, I scored a 52 out of 100 and I felt exhilarated! But when I turned to look at Wendy, she was weeping as though her pet gold fish was dead. And then I realised that she was so disappointed with herself because she only managed to score a 95 instead of a 100, which was her usual score. As for Harold, he usually 'co-top' the class with Wendy. It was either him or Wendy." Sean explained.

"So, did either of them top the class in the end?" The old man questioned.

"Wendy topped the class and Harold was third. Interestingly, this fellow named Kenneth came in second. Kenneth was a brilliant guy, but he did not do well until the final exams. So it was a surprise when he actually beat Harold."

"So if your classmates were businesses, and the results of the final exams were the profits these businesses made, Wendy and Harold will be the best bets. Am I right to say that?" The old man asked.

"Yes, that is absolutely right." Sean answered.

"Would you bet on Kenneth instead of the 2 of them?" The old man asked. "Well, I will rather bet on the 2 of them. Their results had been more consistent."

"Ah ha! That was what I wanted to hear. Consistency!" The old man said. "In order words they had great track records."

"Exactly. They had great track records." Sean repeated.

"In businesses, track record is everything. It will prove whether we are right, when we suspect that the business has a durable competitive advantage." The old man announced.

Track record is Everything

Author's Note:

Where to Find The Track Records?

The internet has made things so much easier for us to pull out a company's financial report. I would like to share some websites that is useful for investors for Singapore and US Stocks

For US Stocks:

- 1. Msn Money Central (http://money.msn.com/)
- 2. Yahoo Finance (http://sg.finance.yahoo.com/)
- 3. Google Finance (http://www.google.com/finance)
- 4. Y Charts (http://ycharts.com/)

There are many websites providing information regarding the US Stocks. So the above mentioned are just some of them which had been widely used. Most of the websites produces similar data but may have difference due to the usage of different accounting terms.

For Singapore Stocks

- 1. Share Investor http://www.shareinvestor.com/) Paid Website
- 2. Bloomberg Businessweek (http://investing.businessweek.com)
- 3. Yahoo Finance (http://sg.finance.yahoo.com/)

For Singapore Stocks, at the time of writing this book, the author did not find any websites that provides a 10 year financial data for free. The Share Investor website provides this service and you have to pay a subscription fee to it. There were talks about local brokerage firms providing the data if you open an account with them which is generally free.

Another way is to visit the company's website directly and look for "Investor Relations" or any term that seemed equivalent. This will be the place for you to download the company's past financial reports.

Reading the company's annual reports allow you to understand the business much better and will allow you to make better decision on whether to buy the business.

PROFITS

"Oh, what do you mean by that?" Sean asked.

"If a business does have a durable competitive advantage, it will be able to earn consistent profits, year after year. And in fact, as business buyers, that is the main thing we want from a business, *Consistent Profits*!"

"This is logical. It doesn't make sense to have a business that seems to be great but it is not making consistent profits. Occasionally, a business like Kenneth may appear. It seemed great, but it did not perform consistently, so it is better to have Wendy and Harold as businesses instead."

"Very good, sonny. You are thinking like a Value Investor. Take the business view approach and continue to think like that." The old man gave Sean a pat on the back. "Now let's go on and have some practice. Turn on your laptop and get connected, we want to look at some track records."

As Sean is starting up the laptop, the old man commented, "Gone are the days, where only a few privileged investors can get hold of a business' information.

Now it can be found easily and is accessible to everyone with the help of the internet."

"We are connected, Sir. Where do we look?"

"Go to any of the financial websites, and type in a stock ticker symbol. What have you got on your list?"

"I have got Ford Motors, ticker symbol 'F' on the top of my list. I suspect it has a durable competitive advantage, based on the 5 questions. It has a strong reliable brand."

"Great, we will start with that. The first thing we should look at is Ford Motor's past historical earnings per share. You can go to the 10-year data. Financial websites beautifully lay out the track records so that we can take one glance and see 10 years of records."

"Here we are. Ford's earnings per share for the past 10 years."

Ford Motor's Earnings Per Share from 2001 to 2010.

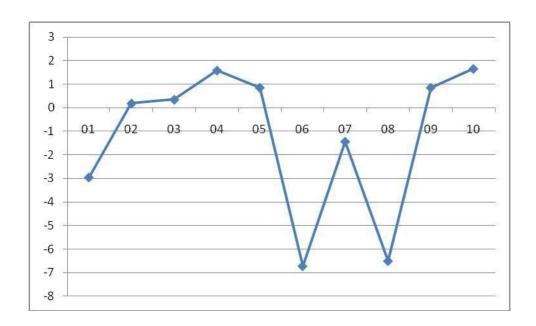
Year	Earnings Per Share
2010	1.66
2009	0.86
2008	-6.5
2007	-1.43
2006	-6.72
2005	0.86
2004	1.59
2003	0.35
2002	0.19
2001	-2.95

[&]quot;How does it look to you, sonny?" The old man asked.

[&]quot;Well, I am not sure. How do I know if it is good?" Sean asked.

[&]quot;Let's draw it on a chart and see if you like the visual"

Sean plotted Ford Motor's 10 Years EPS on the chart and looked at it.



"Woah. There are many ups and downs. And there are years that Ford is making lossess. Doesn't seem good to me."

"Remember the key we are looking for is consistency. Do you want to own a business that reports ups and downs to you and some years of losses to you?"

"Isn't it common for businesses to have ups and downs and losses?" Sean questioned.

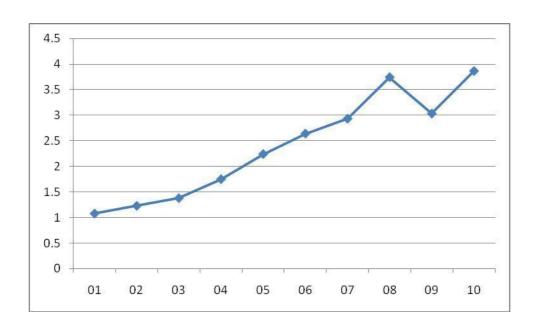
"It is common, for common businesses. And what we are looking for, are exceptional businesses. With a durable competitive advantage, the business can consistently make profits, and can survive the downturn of the economy so much so that even in down times, the profits do not drop too drastically, or even continue to rise." The old man explained. "Well, I suggest we move down your list and see if any of the businesses' track records jump out at us."

"Next on my list is Nike, ticker symbol 'NKE'." Sean announced.

"Nike? Great! This should be a good contrast. Let's take a look at it." The old man commented.

Nike's Earnings Per Share from 2001 to 2010.

Year	Earnings Per Share
2010	3.86
2009	3.03
2008	3.74
2007	2.93
2006	2.64
2005	2.24
2004	1.75
2003	1.38
2002	1.23
2001	1.08



"Wow. That looks like a nice steady business." Sean commented.

"Yes, it looks like a nice business, doesn't it? Is it a business you would like to buy?" The old man probed.

"Well, of course. The earnings per share is nice and consistent. I will like my business to report a nice profit to me every year."

"So do I. And that is why I choose businesses that have a durable competitive advantage and have a good track record to prove it," The old man folded his arms and smile. "Now, go and run down your list and filter off businesses' whose records do not suggest a durable competitive advantage. We will keep those you would like to buy as businesses and we will throw the rest back into the sea."

Author's Note:

Earnings Per Share

A business with a durable competitive advantage will have the ability to make consistent profits. And since we are buying shares and becoming share holders, we want to know how much each of these shares had been earning. Thus Earnings Per Share will be the first criteria when we look at its track records.

Earnings Per Share = Net Income

Outstanding Shares

For example, this year, ABC Company has 10,000 outstanding shares and makes a total profit of \$100,000, its earnings per share will be calculated as:

Earnings Per Share = \$100,000 = \$10 Per Share 10,000

This means that if you own an ABC share, it has earned you \$10 this year. So imagine yourself as the business owner of the company, would you like it to report nice profits for a year then dips or even losses at times? Or do you want to hear and see a nice consistent growing profit year after year? An exceptional and well run business is able to produce consistent and growing profits and that is the kind of business that can be valued and thus be bought at a sensible price.

IPOs

As Sean continued to filter businesses from his lists, he found some companies that do not have 10 years data. "Sir, this business does not have 10 years of data. It only has 5 years. What do I do with it?"

"You should look at the performance for the past 5 years then. However, since it does not have a long track record, we will need to add a wider margin of safety when we estimate the buying price later." The old man replied and continued fishing, drinking his coke and occasionally munched on his burger.

"I see. What about this company, GNC? It is go for its initial public offerings (IPO) in next month. I suspect it has a durable competitive advantage. Should we go and buy some of it?" Sean asked. It was 2011 and GNC was attempting its $\frac{rd}{3}$ IPO, expected to be listed on New York Stock Exchange and trading under the symbol 'GNC' in April.

The old man looked up, "The only time to buy these is on a day with no 'y' in it".

The only time to buy these is on a day with no 'y' in it

Sean was taken aback, "No 'Y'? That means never? Buy why do you say that?"

"I say that because I am a Value Investor and I look for bargain stocks. In an IPO, the investment banker has all the knowledge and information about the business and is offering the uninformed a price he sets. It is very unlikely that he will offer a bargain price. I rather wait for the stock to be trading for some time and confirm its performance. And when Mr Market misprices it, this is when I will go in to get the bargain. But not at IPO, it does not make sense."

Sean was getting used to the old man's wisdom. What the old man suggested always seemed to be counter-intuitive at first, but when it was explained, it made so much sense that Sean wondered why it was not something common in the first place. As he was having that thought in mind, he could almost hear the old man reply, 'Common sense is not always common.'

Value Investing is about common sense, buying great businesses that make sense, at a price that makes sense.

Efficiency And Profitability

"Here Sir, I have filtered off those businesses that do not have consistent historical earnings per share. And I must say that I am surprised that there are in fact, quite a few big brand names that are not doing as well as it looked. But there are still many businesses which I suspect have durable competitive advantage showing a nice consistent Earnings Per Share." Sean was excited.

"Once you manage to identify possible businesses with durable competitive advantage, you will not be surprise to see good results on their score sheets. The next thing you will want to check regarding the businesses you are left with on your list is 'Efficiency'." The old man was moving on to the next criteria. Sean perked his ear to listen.

"Sonny, your list has some gems. They have track records of being able to consistently produce profits for their owners. But we want to choose the most efficient businesses, we want businesses that are able to best utilize the resources they are given, or are keeping within the business."

"Oh, of course. But how do we know which business is more efficient? Don't the Earnings Per Share show it already?"

"Earnings Per Share shows us how much each share had been earning. We want to find out how efficient the business had been.

The way to find out is to look at the Return on Equity or ROE of the business. In this case, we want a business that has a consistent, average ROE of more than 15%, the higher the better, because it suggests higher growth and more efficient use of our equity

Author's Note:

Return on Equity

Return on Equity measures the rate of return on business owner's interest or equity.

Return on Equity = <u>Net Income</u>

Share Holder's Equity

Each time a business makes profits, it can use it in a few ways.

- a. Issue profits out as dividends
- b. Retain the profits which adds to the Shareholder's Equity
- c. Reinvest in itself by either expanding or buying back its own shares.

In other words, the profits which the business has made can either be issued to us, or kept by the business for continued operations or investments. If the business is keeping the profits, it is kept mainly as part of the owner's equity and we want to know that this amount of money is put to efficient use. Return on Equity tells us how well this amount of money has been used.

For example, ABC company makes \$100,000 this year and the amount of share holder's equity it is holding is \$5,000,000.

Return on Equity = \$100,000 = 2% \$5,000,000

What?! We had either put or keep \$5 million with ABC company and it only made 2% or \$100,000 out of it. That is simply not efficient and thus ABC company does not seem like a good place to put our money in. As a gauge, we should look for companies that have a consistent average ROE of 15%.

CROSS CHECKING

The old man shared this story with Sean:

"There was a boss who wanted to employ a manager for his company. He had 3 candidates and thus wanted to test to see who was the best candidate. The first candidate walked into the interview room and sat down. He was a mathematician. The boss of the company said, "I will ask you a question and I require you to answer it as fast as you can." The mathematician nodded to indicate that he was ready. The question burst out at the rate of a machine gun firing bullet, "WHAT IS 2 PLUS 2?". The mathematician, immediately replied, "It is 4.00000000..., how many decimal points do you want?" The boss was pleased. He wanted someone who could react to sudden outbursts and remain calm. He commented the mathematician and told him he will be informed of the interview results.

The next candidate was an engineer. After the boss explained his demand, he was administered the same question, "'WHAT IS 2 PLUS 2?!", yelled the boss.

"It is between 3.9875 and 4.01526." The engineer replied calmly. He went on to explain, "There isn't any perfection in engineering terms. We have to factor in deviations." That impressed the boss.

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The 3 candidate was an accountant. He too was asked the same question

with the same manner, "WHAT IS 2 PLUS 2?" The accountant did not respond.

Instead he slowly moved towards the boss and asked softly, "What number

would you like it to be?"

The lesson: Numbers can be manipulated."

Sean laughed at the story and commented, "Interestingly, creativity is sought

after in most industries except accountancy."

"You are right, sonny. And it is our responsibility as business buyers to do our

own checks. Are there plenty of honest accountants and management around,

but we want to do our own checks.

You see, Return on Equity is becoming a popular criterion for investors to

check the profitability of businesses. Thus managements are motivated to

reflect a higher Return on Equity to attract investors. The best way to do this is

to make more profits with the given amount of equity. Unfortunately, there is

another way to go about it."

"By reducing the equity given the same amount of profits made?" Sean asked.

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"Exactly. And this is not healthy." The old man stated. He began to draw on a piece of paper to illustrate this.

Every business needs a certain amount of assets to operate and function. These assets can be cash, equipments, furniture etc. And these assets are either supported by the use of the business equity, which belongs to the owners of the business, or liabilities, which are debts the business owes.

Take for example, a business that requires \$1 million of resource to operate, and it is financed by \$300,000 of equity and \$700,000 of liabilities.

\$1 Million Worth of Assets (Resources)

\$700,000 Liabilities (Debts)

\$300,000 Equity

This business makes a profit of \$30,000 this year. Its ROE will be \$30,000 divided by \$300,000, which makes it 10%

And if a business choose to shrink equity, not because it has become more efficient and needs less resources, but is doing so just to manipulate the figures to make its Return on Equity higher, they have no choice but to increase liabilities. So imagine the business shrink its equity to \$150,000 by issuing out dividends. But the fact is the business still requires \$1 million of resource to function. It can only do so by increasing its liabilities by \$150,000.

\$1 Million Worth of Assets (Resources)

\$850,000 Liabilities (Debts) \$150,000 Equity



Reducing \$150,000 of equity and this in turn leads to increase borrowing of \$150,000 increasing Liabilities from \$700,000 To \$850,000

But with the decrease in equity, the ROE figure is now very different. ROE is now \$30,000 divided by \$150,000, making it 20%, instead of the previous 10%.

"Wow, cool. It is like magic. And that is why the accountant can ask what number the boss wants. But is there anything detrimental about shrinking equity and increasing liabilities?"

"The cost of debt is interest rate and that can be very costly. The cost of equity on the other hand is naggy owners, which is sometimes, very pressurizing and irritating, that is all. But for a business, they have to act in the best interest for the owners. Period."

"I will love for you to run my businesses. You have such strong principles!" Sean praised the old man.

The old man laughed. Sean laughed with him.

"Well sonny, in order to not let creative accounting and management fool us into believing the business is efficient, we need to do some cross checking. In this case, we will cross check that the Return on Assets is high as well. The Return on Assets must be at least more than 7%. If the Return on Equity is consistently high, but the Return on Assets is not high, it may not mean that the business is efficient."

Author's Note:

Return on Assets (ROA)

The Return on Assets shows how profitable and efficient the business is in generating income with the amount of assets it has.

Return on Assets = Net Income

Total Assets

For example, ABC Company made \$100,000 this year. It has \$300,000 in equity and \$700,000 in liabilities.

ABC has a total asset of \$300,000 (Equity) + \$700,000 (Liabilities) = \$1,000,000.

The Return on Assets for ABC = $\frac{$100,000}{1,000,000}$ = 10%

As a gauge, we want to find businesses that have high Return on Equity and high Return on Assets.

HEALTH CHECK

"Sir! Are you alright?" Sean got the news from the old man's secretary that he was in hospital. He rushed to the old man's ward and found him lying on the bed with some annual reports, a hamburger and a can of coke on his table.

"Hi Sonny." The old man greeted. He was surprised at how anxious Sean looked.

"Your secretary called me and informed that you are in hospital and you would like to see me here. I thought your diet of hamburger and soft drink has gotten the better of you. But you do look fine."

The old man burst out laughing, "Ha ha! Linda does need to improve on her communication. Maybe she should attend a public speaking course as well. I am just here to do my regular health check. And since I am required to stay here for quite a while, I thought we will be missing our fishing today. Want to play bridge instead?"

"Regular health check? You guys got me worried for a moment." Sean wiped the sweat off his brow while taking deep breaths. It was obvious he came in a rush. "Sonny, do regular health checks!" the old man advised. "Imagine you had a car and that was the only car you would have for your entre lifetime. Of course, you would care for it, changing the oil more frequently than necessary, driving carefully etc. Now consider that you have only one mind and one body. Prepare them for life, care for them. A person's main asset is themselves, so preserve and enhance yourself.

A person's main asset is themselves, so preserve and enhance yourself

"Yes you are right but WHAT IS THIS!" Sean pointed triumphantly at the can of coke and half munched hamburger lying on the old man's table.

The old man was dumbfounded for just a moment but he recovered his composure and replied, "I have decided that the increase in life expectancy I get from eating less of these is not worth the decrease in the pleasure After all, while you preserve yourself, you have to enjoy". He then took a huge gulp of coke and let out a satisfying, "Arhhh..."

"Sir, sometimes you are just impossible!" Sean groaned playfully.

The old man just smiled and continued to drink his coke, "I told Linda to get you here because I thought that this is a good place to continue where was had left in our coaching."

"Oh? Great!" Sean grabbed a chair by the bed and simultaneously pulled his journal out, ready to take notes.

The old man waited for Sean to settle into his seat and continued, "Just as I mentioned earlier, our asset, so we need to do regular health checks on it. In fact, before we decide to buy a business, we have to conduct a throughout health check on the business."

Sean probed, "Health check? By that I guess you mean its financial health."

"You are spot on." The old man nodded. "Tell me what you know about reading and analysing the financial health of a business."

"Well, in Business School, I was taught that there are basically 3 types of financial reports and I guess that is pretty much all I know. I am not really sure how to string the numbers together."

"Whenever I look at these financial reports, I get confused. There are so many numbers and I don't really know where to look. And I am also not sure how to do those sophisticated calculations."

"Sophisticated calculations? As I mentioned, if sophisticated calculations are needed for investing, I will be back to delivering newspapers." The old man chuckled. "When we started looking at Return on Equity and Return on Assets, we are in fact doing a financial health check. In this case, we are checking for its strength."

"Today, we will look at something different. We want to see if the business can has any danger signs."

DANGER SIGNS

"Danger signs?" Sean asked.

"Yes. When the doctor conducts a regular health check for me, he checks for mainly for danger signs. A person can perform at his peak most of the time because he has some strength. And from time to time, things just happen that changes the environment. So while he can perform in good times, he must be able to survive bad times. And one such danger sign is when the business carries too much debt." The old man announced.

"Ah... That makes sense. Debt is dangerous isn't it? That is why many people aim to be debt free early in life." Sean casually remarked.

"Sometimes, debt is necessary. For example, when a young couple start their family and want a house. It may be difficult for them to pay in full, and thus it makes sense for them to borrow from the bank to finance the house instead of saving for years before they can pay in full. And if a business wants to expand its operations, it may make sense for it to take on some debts instead of waiting years to build up its resources. And if the business have a durable competitive advantage and is able to make consistent, exceptional profits, taking on debts to expand the business will benefit the owners in the longer run since they are efficient in using the assets to churn more profits." The old man shared his view point.

"That is brilliant! So, wouldn't we want the businesses that have durable competitive advantage to borrow more so they can have more resources to churn more profits?" Sean asked.

"Well, we want them to borrow conservatively. This is because we are not able to predict the economy or events. So there may be times where the entire economy goes into bad times and everyone loses businesses. Times like these happened and will continue to happen. As much as I think the government is doing their best and we are getting better leadership, some things are just inevitable, like market cycles. And do note that debts are costly; the price of taking on debts is interest rates, which will start to compound if the business is not able to pay it back.

Just imagine a talented violinist who is paid well to play the violin. He may have a distinct advantage of having superb skills of playing the violin and is consistently demanded to play. But there may be times when the economy turns bad and by no fault of his, most people, even though yearned for his services, are not able to pay him and stopped engaging his services. He will probably have some business but not as much as when the economy is doing well. If this young violinist had been keeping reserves and has low debts, he will be able to survive. But if he has high fixed expenditure and high debts, his reduction in income during bad times, may mean that he will not be able to finance his debts. And debts, like snowball will compound if you do not pay. This is how many gifted individuals go into bankruptcy. I am sure you can think

of some famous highly paid celebrities who had excessive debts and faced such financial embarrassments. In fact, there are plenty of examples."

"Oh yeah, there are plenty of them out there." Sean could remember immediately. "So it is the same for businesses right? In fact, I was thinking, if the business we choose has a durable competitive advantage, it should be making enough money to finance its own operations. Hmm... so how much debt is too much?" Sean asked.

"A rule of thumb is to have a business that has long term debt not more than 5 times its income. So if we have done our initial checks right, it means that the business should be able to generate consistent income and thus able to pay its long term debt within 5 years. Any more than 5 years is not comfortable."

"That sounds reasonable. I will check on these lists to see if they have too much long term debts." Sean continued to study the businesses on his list.

Author's Note

How to Check if business has too much debt

Traditionally, the ratio used to see if the business is conservatively financed in debts, is to use the Debt to Equity ratio. This ratio measures what proportion of equity and debt that the company is using to finance its assets. It is almost like comparing a person's amount of debts to his net worth. Thus it is not very comfortable to see a person having more debts than his net worth. In fact, if his debt amounts of more than half his net worth, he should not be feeling too comfortable.

The reason why we choose to compare the amount of debts to the net income instead of debt to equity is that we are buying businesses which we want to hold so that it can continue to generate profits. Having net income that can pay off the debts and thus its interest, means that it can survive bad times and not go insolvent. Comparing debt to equity makes more sense if we expect the business to sell of its assets to pay of its debts.

To check for long term debts, we can go to the Balance Sheet in the financial websites or the business' annual reports and find its long term debts or long term liabilities.

To check for net income, look under the income statement and look for Net Income or Net Profit.
Take Net Income and multiply it by 5. The total figure should be more than its long term debt.
E.g. If you use Msn Money and check for IBM's 10 Year Summary, you can see that for Dec 2010, IBM has a Total Net Income of 14,833million and a Long Term Debt of 21,846million.
If we multiply IBM's Total Net Income by 5,
We get 14,833million x 5 =74,165million.
74,165million is more than its Long Term Debt of 21,846million. So IBM is not holding too much debt.

Interest Coverage Ratio

Another check we can do it Interest Coverage Ratio.

The Interest Coverage Ratio is used to determine how easily a company can pay interest on outstanding debts. It is calculated by dividing the company's earnings before interest and taxes by the company's interest expenses.

Interest Coverage Ratio = <u>EBIT</u>

Interest Expenses

Where EBIT = Earnings Before Interest and Taxes

We want a interest coverage ratio of at least 3. This means that the amount of profits made by the business can easily allow it to pay 3 years of interest. This means that the business is able to survive 3 years of down time in its business and it still able to pay its interests. This is important because if a business is not able to pay its interest, the amount of debts is going to roll into a bigger amount. This is the time we do not want compounding to work against us. As such, having the ability to pay its interest suggests it is able to prevent such a situation from happening during poor economy and can last until it survives the bad times.

PRICING POWER OF A BUSINESS

"The next danger sign is this, if a business does not have the power to raise price without losing business. If you got the power to raise price without losing business to a competitor, you have got a very good business. And if you have a prayer session before raising price by 10 percent, then you have got a terrible business." The old man said.

"Why is this a danger sign?" Sean asked.

If you got the power to raise price without losing business to a competitor, you have got a very good business. And if you have a prayer session before raising price by 10 percent, then you have got a terrible business.

"I loved drinking coke since I was young. And I remember when I started distributing papers; I earned enough money to buy my own coke. At that time, it cost only 5 cents. However, whenever I wanted to buy coke, I could hear my dad's reminder that I should learn to save and not spend my money. So instead of buying coke, I saved those 5 cents. Just about 5 years later, I realised that the price of a coke is 10 cents. This meant that my 5 cents could only buy me half a coke! I should have bought and drank that coke 5 years ago. From that point onwards, I learnt two important lessons. The first is to grow and invest

my money, otherwise I will be poorer instead of richer since the amount that I had saved could only afford to buy less over the years." The old man paused and drank his coke.

"What is the 2 lesson that you learnt?" Sean asked.

"The 2 lesson is not to deprive myself of coke!" The old man chuckled as he continued drinking his coke.

Sean laughed and then realised that his initial question had not been answered yet. "So, why it is a danger sign if a business cannot raise prices?"

"Inflation! Sonny, year after year, prices increase. This means the cost of doing business increases as well. And imagine a business that is faced with increasing costs, yet couldn't raise prices because it would lose customers, isn't it dangerous?" The old man asked.

"Oh yes, that does not sound good for any business." Sean replied.

"Can you think of any products or services that are lowering prices year after year to keep its businesses even though the prices of everything else are increasing?" The old man asked.

Sean thought for a moment. "Telecommunication services are one of them. Others include air tickets and internet services."

The old man nodded. "I would avoid these businesses. And I would suggest you avoid them too. These are known as Price Competitive Industries. These industries completely purely on price and their customers decided purely on price as well. Whenever a business offers a lower price, a customer will jump ship and go over to the lower price company. There is not sense of loyalty as there is not product differentiate. We want to avoid these industries."

Sean quickly noted what the old man said in his journal and strike of some of the businesses on the list that he suspected were price competitive businesses.

THE HORSE OR THE JOCKEY?

"Sir, I have not heard you talking about the management of the business, aren't the management important?" Sean asked.

"It is always good to have good and talented people running the business. But we must be careful not to choose businesses whose performance is dependent on the management's performance. This is because talented people can be transferred by paying more to get them to jump ship. We want to avoid businesses whose performance will drop when a group of people moving away means it loses it competitive advantage. This kind of competitive advantage is not at all durable. Instead, we want to buy businesses that even a fool can run, because someday a fool will."

Buy businesses that even a fool can run, because someday a fool will.

Sean nodded. "Head hunters are always out hunting for talents and job loyalty does not seem like the popular thing these days. If a business is dependent on a few people, it will be at the mercy of these groups and will have to bow to any demands they made. We want businesses that are valuable because of the business, and not the people."

"That is right. Extraordinary businesses do not require good management. But it is important that they are honest people. So if we are doubtful if we should buy the business because we have doubts about the integrity and honesty of the management, we should not go into the business at all." The old man stated.

Extraordinary businesses do not require good management.

The lessons the old man shared all seemed to be common sense after he explained them. It all seemed so logical that Sean began to wonder why no one else seemed to think this way. He did not realise that the way he thought had changed radically since he first met the old man. He was now seeing stocks as businesses. He had put on the lens of a Value Investor.

Author's Note:

Summary of Criteria

We have gone through a set of criteria to look at when we are analysing a business. This is a summary or a check list for you to get started to analyse the businesses you are interested to buy

- 1. Durable Competitive Advantage
- 2. Consistent Historical Earnings Per Share
- 3. Consistently High Return on Equity (more than 15%)
- 4. Consistently High Return on Assets (more than 7%)
- 5. Conservatively Financed in Debts
 - 5 times Net Income > Long Term Debt
 - Interest Coverage Ratio > 3
- 6. Able to Raise Prices

Other notes:

- Avoid IPO. Wait until they have track records so we can analyse them.
- Choose Businesses not dependant on talented people or the management.

Now that we have a check list to analyse businesses. You can use it to filter off any business that does not pass these criteria. Do note though that these are guidelines and the most important factor about businesses is their ability to consistently make profits. These guidelines help us determine if a business can do so. But if you have strong enough reasons to believe otherwise, you should give the business a miss. On the other hand, if you have reasons to believe that a business can consistently make profits in the long run and has a durable competitive advantage, you may choose to buy it even though it does not strictly passes all the criteria.

You should therefore buy businesses which you can understand.

Remember to think 'business' as this is the lens you should put on to become a Value Investor.

The next part of the book, we will go into buying these great businesses at what Warren Buffett calls, a sensible price.

Part 4: Sensible Price

PRICE AND VALUE

"Now that I have a couple of businesses to buy from, how do I go about doing it?" Sean asked. "I remembered you mentioned about buying them at a sensible price. How will we know it is at a sensible price?"

"Good question. To buy businesses at a sensible price means that we only pay at a price that makes business sense. That in turn means that the returns must make sense. Very often we try to buy the business at a discount, that is to say we do not pay for any more than what the stock is worth."

"But how do we know how much a stock is worth?"

"That is the interesting question." The old man smiled. "It is an estimate actually. Let me ask you, how much did you pay for your phone?" The old man asked, pointing to Sean's mobile phone on the jetty.

"Oh that phone, about \$400." Sean replied. "\$400? That is quite an expensive phone. Were there cheaper phones?" asked the old man.

"Oh yes of course. Some phones are free when I sign up for the plan." Sean said.

"Free? Then why did you buy this phone instead of getting a free phone?" The old man was surprised.

"This phone is different. It is not just a phone. It has GPS function, I can watch movies, check my email, take pictures, have high speed internet and it allows me to download many free applications, both for work as well as entertainment. It is definitely worth \$400 more than those free phones."

"I see. Your phone sounds amazing. And it does sound like it is giving you at least \$400 worth of value more than the free phones. I am just curious, what is the highest price you will be willing to pay for this phone?" The old man remarked.

"Yes it is. I will probably be willing to pay up to \$700 for this phone. Let me see. Yes I think \$700 is the maximum." Sean replied.

"Good. That is probably how much value the phone is giving you. Now, what is the value of this business?" The old man asked, pointing to one of the ticker symbol on the list of stocks in Sean's journal.

"This? That is Nike and it is selling at \$83.62 when I checked last night." Sean asked.

"Ah sonny, \$83.62 is the price, not the value. Price is what you pay and value is what you get. Take a closer look at what you are buying if you choose to buy these businesses. What is the value you are getting? Just as you were sure and certain about what kind of value your phone is giving you and there is where you can tag a price to it, you should first be certain of the value a stock is giving you."

Price is What You Pay, Value is What You Get

"The Value a stock gives me?" Sean pondered for a moment. "Well stocks are businesses, so when I buy a business, what is the value that it gives? Is it the ability to generate profits? Yes, that must be it."

The old man nodded and looked satisfied with Sean's answer. "Sonny, you are getting better and learning faster as we move along. So how much will you be willing to pay for the businesses?"

"Hmm. That is a difficult question. Any hints?" Sean asked.

"Let's say I own a business that has been consistently making me \$1million every year for the past 10 years. And I put it up for auction so that people can bid for it. How much do you think people will bid up to?" The old man asked.

"Well, I guess the starting bid should be more than \$1million since there is no reason why you will sell your business for anything lower than that. I think the bid will probably go up to \$10million?" Sean made his guess.

"Will you be willing to buy this business at \$10million if you have the money to do so?" The old man asked.

"If the business has been consistently making \$1million, I will assume it will continue to do so. Thus, if I buy it at \$10million, I can expect about a 10% returns every year. That is not bad. If I have the money to do so, I will probably buy it." Sean gave his analysis.

The old man replied. "I like the way you think. That is business thinking.

Sometimes, it takes a long time for people to really understand the truth that stocks are businesses. So they buy stocks hoping that it will go up in price. And hope is not an option for Value Investors."

"Yes, I remember that you only go for bets that you know you will win." Sean commented as he remembered the fishing competition where the old man used a fishing net against him. "In evaluating how much to pay for a business, we look at how much profits it can make. But these businesses that we have shortlisted have been making consistent and growing profits year after year, and this would mean that the price goes up year after year as well. In fact since the business has been doing so well, people will want these businesses and the

price will be jacked up. In that case, we will not get a good chance to buy them, would we?"

The old man adjusted his glasses slightly and announced, "Sonny, it is time to introduce you to a good partner of mine... Mr Market!"

MR MARKET

"Mr Market?" Sean asked. "I heard you mentioning this term a number of times. Who or what is Mr Market?"

"I was introduced to Mr Market by my professor. It is probably one of the single most important concepts that I have heard with regard to investing. It says that when we are investing in the stock market, to imagine we have a partner, called Mr Market. Everyday, Mr Market would come and offer to sell you interest in his businesses. But there is something about Mr Market you must know." The old man then lowered his volume and whispered, "Mr Market is a psychotic."

"Huh? What do you mean Mr Market is a psychotic." Sean asked, getting more curious by the moment.

"Mr Market has terrible mood swings. Some days, when he comes to offer you businesses, he would be so depressed that he feels suicidal. During these times, he just wants to dump his businesses away and would sell them to you at low prices. And there are times; he would feel so high, as if he was on drugs. And when he feels high and optimistic, he would offer to sell you businesses at a high price." The old man was so animated that Sean could imagine in his mind, a mysteriously man in coat who would come to his house every day, with all sorts of facial expression.

"Sonny, you have identified a list of great businesses. When will you want to buy it from Mr Market? When he is depressed or when he is high?"

"When he is depressed, of course. I want to buy it cheap." Sean replied, certain that it was the right answer. "But sir, does Mr Market exist in the real world?"

"Mr Market has been around for a long time. And he has not changed ever since I know him. It is easy to show you his existence really. Let's take any example of your list and you can see Mr Market in action."

"How about IBM?" Sean asked.

"IBM? Let's take a look at its 10 Years Earnings Per Share."

IBM's Earnings Per Share from 2001 to 2010.

Year	Earnings Per Share
Dec 2010	11.52
Dec 2009	10.01
Dec 2008	8.89

Dec 2007	7.15
Dec 2006	6.06
Dec 2005	4.91
Dec 2004	4.39
Dec 2003	3.75
Dec 2002	3.07
Dec 2001	4.59

"Consistent, growing Earnings Per Share. Beautiful business isn't it?" The old man commented.

"Yeah, it is a business that I would like in my portfolio" Sean said.

"Sonny, like what you said, IBM's share price should mirror its earnings and should go up year by year. Now add on another column with the historical price of the shares beside the Earnings Per Share figure.

IBM's Earnings Per Share And Share Price from 2001 to 2010.

Year	Earnings Per Share	Share Price at End of Dec
Dec 2010	11.52	\$147.2
Dec 2009	10.01	\$131.2
Dec 2008	8.89	\$83.89
Dec 2007	7.15	\$109
Dec 2006	6.06	\$97.18
Dec 2005	4.91	\$82.45
Dec 2004	4.39	\$98.97
Dec 2003	3.75	\$92.86
Dec 2002	3.07	\$78.8
Dec 2001	4.59	\$120.6

"Sonny, as you can see, IBM has a nice growing EPS, so logical speaking, the share price should also be growing nicely. But there are still times when Mr Market would price it wrongly. For example, can you see that in December 2008, the earnings per share is more than double that of December 2004?"

Sean looked at the figure. The December 2008 EPS was \$8.89 per share while the EPS for December 2008 EPS was \$4.39. "Yes sir, the EPS in 2008 is more than double that of 2004."

"And so should the price in 2008 be twice of that in 2004?" The old man asked, pointing to the 2004 and 2008 prices, which was \$98.97 and \$83.89 respectively.

"Oh! The share price in 2004 is in fact higher than 2008, but the share made more money in 2008. In fact it doubled in 2008. How can that happen? It doesn't make sense!" Sean exclaimed.

"That is Mr Market in action. He does not make sense in the short run. In the short run, the market reacts to news and do not pay attention to what value the business gives. But after a while, a business that can make consistent growing profits will build up on its equity and its capability to increase profits, thus it is just a matter of time that the market will realise the value of the business and price it upwards. However, we do not know when that will

happen and that is why I buy a business on the assumption they will close the market next day and will not reopen for the next 5 years."

Buy on the assumption they will close the market next day and will not reopen for the next 5 years

"So within the time frame of the next 5 years or 10 years, the market will eventually price the business according to what it is worth. Taking IBM for example, in 2008, Mr Market provided a good chance for us to buy it at a good business price. The earnings per share is \$8.89, and Mr Market is offering us at \$83.89 per share, we will be buying it at about 9.5 times of its earning, which translate to about 10.5% yield. And IBM's EPS has a nice consistent and predictable growth rate of about, lets see, more than 15%. Do you think it makes business sense to buy a business that gives a 10.5% yield with a likely growth rate of 15% per year?"

"Well, it sounds like a good deal. So that is what you mean by sensible price. But what if the stock price continues to fall?" Sean asked.

"That may happen. In fact it happened to me in almost every instance. I was never able to pick stocks at the bottom of the market, but whenever I buy them, they make business sense. So if the price falls, I will buy even more of the stocks if I have the funds to do so, otherwise, I will have to wait for Mr Market to eventually realise the value of the business. And you know what, in the short run, the market is a voting machine, but in the long run, it is a

weighing machine. So for IBM's case, in 2009, Mr Market began to price it 13 times its earnings instead of just 9.5 times. You can see that how Mr Market price the business, very often has got nothing to do with how much the business is really worth. Mr Market is a good partner but a lousy advisor, so you must take note that he is here to serve us and not to instruct us."

In the short run, the market is a voting machine, but in the long run, it is a weighing machine

Mr Market is a good partner but a lousy advisor, he is here to serve us, not instruct us

Sean noted what the old man had shared into his journal. He recalled, that not too long ago, he had tried to predict the moods and movement of this psychotic, Mr Market. He had listened to Mr Market's advices and had suffered in doing so. He thought of his other course mates and friends who have entered the stock market. At some level they had all understood that stocks are business, but never knew how to analyse and what to look for in a business.

'We were all part of Mr Market,' Sean thought. 'But not anymore, at least not me.'

TARGET BUY PRICE

"So is there a magical number of how many times we should pay for the business' ability to earn profits?" Sean asked.

"There is no magical number, sonny. It is always an estimate. And we got to take into account the growth rate beside the earnings. And overall, we got to compare across businesses and opportunities and choose one that makes most business sense. The first opportunity we should compare with is any form of 'risk free' investments" The old man replied.

"Risk free investments? Like fixed deposits and government bonds?" Sean asked.

"Yes. These are investments that have relatively low risk. Why not invest in them instead if the returns they are given are equal or higher than the businesses you are looking at."

"That is true. Well, a 10 year Treasury bond is giving about 3% and a 30 year Treasury bond is giving out about 4%. If we compare this to IBM in 2010, we will be paying \$147.20 for an earnings of \$11.52, that is 7.82%. This means it makes more sense to buy IBM when we compare it to Treasury Bonds." Sean remarked.

"That is right sonny. And note that IBM's EPS has a historical growth rate of about 15%. And if we think that IBM can continue to have such profits at such growth rate, doesn't it make more business sense to buy IBM instead of Treasury Bonds?" The old man asked.

"Yeah, it seems more logical to buy IBM at that price. So is that what I should do? Compare the business with risk free interest rates and buy if it makes sense?" Sean asked

At this point, the old man pulled out 2 financial calculators from his jacket and passed one to Sean. Sean held the financial calculator in his hands and felt a chill went down his spine. He had not used such a calculator since his university days. It felt nostalgic but at the same time so unfamiliar and scary.

Author's Note

I want to pause right now as we are moving into more calculations. The gist behind comparing investments is always to see which investments give a higher rate of returns, assuming that we have done our due diligence and are comparing investments that have a durable competitive advantage which will continue to perform.

A treasury bond is a bond issued by the government to fund their projects. In simple terms, if we buy a treasury bond, we are lending money to the government and they in return will pay us interest. This amount of interest is

regarded as a risk free investment.

It is a good practice to keep our eyes on government bonds or highly rated bonds which are risk free. The interest rates offered for these bonds fluctuates over time and thus when the interest rates on these bonds offer better returns than buying businesses from the stock market, often due to inflated stock prices, a Value Investor may choose to put his money into bonds instead.

We are going to continue this segment by going through a calculation process to derive a target buy price for the businesses. There will be case studies and examples for you to go through and understand better. As you continue to read from here onwards, first take time to understand the logic behind the calculations. From point to point, I will pause to give you some explanations or resources that I think will be useful to you. At the end of this segment, I will also be waiting for you with a summary note.

You should then get some hands on practice. Let me tell you this, this skill will pay off handsomely, so you will want to learn it!

"In order to help you derive a target buy price, I will break it down into 5 steps:

Step 1: Find EPS Annual Compounded Growth Rate

Step 2: Estimate EPS 10 Years from now

Step 3: Estimate Stock Price 10 Years from now

Step 4: Determine Target Buy Price Today based on Desired Returns

Step 5: Add Margin Of Safety

Let's use a business that you have on your list as an example." The old man offered.

"Let me see. How about Coka Cola, ticker symbol KO." Sean suggested.

"Let's use that. The 1st step is to find the EPS annual compounded growth rate for the past 10 years. To do that we need the 10 EPS data."

KO's 10 Years EPS Data from 2000 to 2009

Year	EPS (\$)	Year	EPS (\$)
2000	0.88	2005	2.05
2001	1.6	2006	2.17
2002	1.23	2007	2.59
2003	1.77	2008	2.51
2004	2.00	2009	2.98

To find the annual compounded growth rate, we use the year 2000's data and key in as Present Value (PV) in the financial calculator and 2009's data as Future Value (FV). From 2000 to 2009, we can say that Coke's EPS took 9 years to compound from \$0.88 in 2000 to \$2.98 in 2009. Do note that although there are 10 years of data, there is only 9 years for Coke's EPS to grow from \$0.88 to \$2.98. Let me illustrate this so that you are very clear on this." The old man begin to draw.

10 Years of Data, but only 9 years to grow									
Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10
2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
0.88	1.6	1.23	1.77	2.00	2.05	2.17	2.59	2.51	2.98
Grow 1 time Grow 2 times 3 times 4 time 5 times 6 times 7 times 8 times 9 times									

"Ah, that is clear. Although there are 10 data years, but the EPS grows 9 times." Sean repeated what the old man is trying to explain to show that he had understood.

"Good. To continue, We have the Present Value of \$0.88, a Future Value of \$2.98 and 9 years to grow. Key this into the financial calculator and tell me what the annual compounded growth rate is." The old man instructed Sean.

Sean did as he was told and he announced the answer, "It is 14.51%."

The old man did his calculations and nodded in agreement.

Author's Note:

Step 1: Calculating Annual Compounded Growth Rate of EPS

If you do not have a financial calculator, do not fret. There are many websites that provide free calculators for you to calculate the compounded growth rate.

One such resource at the point of writing is:

http://www.moneychimp.com/calculator/discount rate calculator.htm

There are many similar websites, you just need to search for "Compound Annual Growth Rate Calculator" in your favourite search engine.

I suggest you go to one of those websites now and practice using the calculator. Using the following data:

Present Value = \$0.88

Future Value = \$2.98

Years = 9

See if you can generate the figure of **14.51%**

Do note that when we are calculating the historical growth rate, it is taken as an estimate growth rate for the future as well. Thus if for any reason, you believe that the growth rate cannot be maintained, you are free to adjust it downwards. E.g. if you find a business with historical growth rate of 120% and when you analyse the historical EPS and find that for current year, the EPS has jumped tremendously and you are not sure if it can sustain growing at 120% per year, you can choose to adjust the growth rate downwards and disregard the current year's EPS.

Also note to disregard current year's EPS if it is erratic and you feel do not accurate contribute to getting a good estimate of the EPS growth rate. We will remove erratic figures if it is the first data of the 10 years data or the last data. The in between figures do not affect the calculation of the growth rate. And remember if you remove any data, you need to reduce the number of years in the calculation as well.

"Now step 2 is to estimate EPS 10 Years from now. We will do this using the historical growth rate. For KO's case, it is 14.51%. So we will compound it for 10 years to estimate what its EPS will be. This time, we will take 2009's EPS of \$2.98 to be the Present Value and 14.51% as the growth rate, and we will give it 10 years to grow. Do key the following into your financial calculator

Present Value = \$2.98

Growth Rate = 14.51

Years = 10

What is the Future Value, that will be an estimate of EPS 10 years from 2009."

Sean keyed in the figure, "\$11.55". The old man nodded in agreement.

Author's

Note:

Step 2: Estimating EPS 10 Years from now

To project EPS 10 years from now, you can search for an online "Compound Interest Calculator" or you can use one at moneychimp.com.

http://www.moneychimp.com/calculator/compound interest calculator.htm

To practice, using the following data:

Present Value/ Current Principal = 2.98

Growth Rate = 14.51%

Years = 10

(Leave any other information such as yearly addition blank)

You should generate the figure of **11.55**

"Sonny, what we really want is to estimate the share price 10 years from now.

So, since we now have the estimated EPS 10 years from now, we can use the average PE ratio of the share and estimate the share price. We simply take the estimated future EPS multiply by the average PE ratio."

"I see. KO's average PE ratio is 19. So I will multiply \$11.55 by 19 and I will get \$219.45. This is the estimated stock price of KO 10 years from now." Sean stated.

Author's Note:

Step 3: Estimating Share Price 10 Years from now

The PE ratio is the Price to Earnings Ratio. It calculates how many times the market is paying for the share compared to its earnings. Thus

PE Ratio = Share Price

EPS

For example is a business' EPS is \$2 and its share price is \$20, the PE ratio will be 20/2 = 10 times.

You will notice that PE ratio changes daily as the share price changes. Thus the PE ratio of a share can be 10 times today when the share price is \$20, and will change to 9 times, when the share price drops to \$18, because \$18/\$2 = 9 times. In calculating PE, we take the last announced EPS, which only changes every year. So when you check the average PE of KO today, it is probably not 19 times. It will vary daily.

Some resources to find historical PE is msnmoneycentral, or ycharts.com. Or sometimes, you can simply search for "StockTicker Average PE" and you may find some good sites. New and better websites are created every year, perhaps even every day, so we can explore around.

In estimating the future share price, an even more conservative method is to use the lowest PE instead of the average PE. This is especially so if you notice the PE dropping over the years. Another possibility may be to use a figure between the average PE and the lowest PE as a gauge to estimate future share price.

"Now we have an estimate of the future share price, which is \$219.45. We will ask ourselves, what is our desired rate of returns? Personally, I will not go for anything less than 15%. It can be higher, but for discussion sake, we will use 15% as our target. Is that figure fine with you?" The old man asked.

"Hmm, honestly I would prefer 20%" Sean replied, sticking his tongue out, looking a bit guilty.

"20% is good. But you must know that when you aim for a 20% rate of return, you will have to purchase the share price at a lower price than if you aim for 15%. In my opinion that is totally fine. The cheaper the better, the only issue is that chances of you getting at that price will be lesser." The old man pointed out.

Sean digested what the old man had just said and came to a realization, "Ah, that makes sense. If I want higher returns, I must buy it at a lower price. And lower I aim, the lesser the chance is."

"Yes. But sometimes, you got to just wait for Mr Market to throw you a perfect opportunity. And from my experience, he does that from time to time. You just got to be patient." The old man said. "Now, let's aim for the 20% that you want. If we estimate KO's share price to be \$219.45 10 years from now, what is the price we need to buy it today to get the annual compounded rate of 20% that we want?"

Sean thought for a moment, "We will need to discount the share price 10 years back with 20%."

"Go on. How do we do that?" The old man probed further.

Sean thought harder. He knew he had learnt something to do with discount rate in school before, the answer is in him somewhere... "Ah! We will need to take \$219.45 as the future value, take 20% as the discount rate and take number of years to be 10."

"Good. What you have learnt do come in useful if you know how to apply them to real life applications, isn't it. Key in the figure and you should get the target buy price."

Sean smiled at what the old man said. He always thought that what he learnt

in school cannot be applied. He may be wrong after all. He typed on the

financial calculator and got the answer: \$35.44.

Author's Note:

Step 4: Estimating Target Buy Price based on Desired Returns

To 'discount' the share price backwards is the exact opposite process of

projecting the share price forward.

What we have done so far is to project the EPS forward using the historical

growth rate and multiply it by the average PE to get an estimated share price.

In order to get a target buy price today, we will have to discount it backwards

with our desired returns.

To discount the share price backwards, we need to use a "Present Value"

Calculator". Again you can search of the calculator with a search engine or you

can

use:

http://www.moneychimp.com/calculator/present value calculator.htm

Practice using the Present Value calculator by keying in the following:

Future Value = \$219.45

Years = 10

Discount Rate = 20%

You should get \$35.44.

185

"\$35.44?" Sean asked to get confirmation from the old man. The old man acknowledged by nodding.

"Sonny, if you buy KO at \$35.44 today, hold it for 10 years and sell it at \$219.45, you will get the 20% you want. But of course we do not know if that will be the price 10 years from now. Nobody can predict when Mr Market will decide to price it right. It can be 3 months, 1 year, 5 years or 10 years, we will never know. But we can give him a 10 year period for him to be right a few times. And during that few times, we can sell make our 20% per year."

"Oh, that sounds simple enough. But what if there is some error in my calculators or estimations somewhere?" Sean asked.

"As I mention, this is always an estimate. And in order to be certain to account for possible errors like you mention, we will move on to Step 5: Add Margin of Safety!"

"Margin of Safety? What do you mean and how do we add it?"

"Currently, we have identified the target buy price to be \$35.44, we may choose to add at 15% margin of safety to that price and bring it lower down to \$30.124. This is done by deducting 15% off \$35.44."

"I see. So even if I did make some error in my calculation, I will still have a safety net of 15%!" Sean beamed. "But why 15%?"

"15% is just a guide line. If you understood a business perfectly and the future of the business, you would need a very small margin of safety. So, the more uncertain you are about the business is, assuming you still want to invest in it, the larger margin of safety you would need. If you're driving a truck across a bridge that says it holds 10,000 pounds and you've got a 9,800 pound vehicle, if the bridge is just 6 inches above the road it covers, you may feel okay. But if it's over the Grand Canyon, you may feel you want a little larger margin of safety."

Sean absorbed the lesson. The entire process of calculating was a logical one, even though it exhausted him mentally. He took the notes and was determined to practice the process until it became as natural an instinct as the old man had displayed it to be.

Author's Note:

Summary on How to Determine a Target Buy Price

We will take 5 steps to determine the Target Buy Price for the business we want.

Step 1: Find EPS Annual Compounded Growth Rate

To find the annual compounded growth rate, use the "Compound Annual Growth Rate Calculator" or go to:

http://www.moneychimp.com/calculator/discount rate calculator.htm

Step 2: Estimate EPS 10 Years from now

To project EPS 10 years from now, use the "Compound Interest Calculator" or go to:

http://www.moneychimp.com/calculator/compound interest calculator.htm

Step 3: Estimate Stock Price 10 Years from now

To estimate Stock Price, we will need the average PE ratio or the Lowest PE ratio. To find historical PE ratio, you can go to ycharts.com, and click on PE Ratio where the Key stats are displayed.

Use the PE ratio (either average, lowest or in a figure in between), and multiply it with the Estimated EPS 10 years from now, which is the figure we derive from step 2.

Step 4: Determine Target Buy Price Today based on Desired Returns

To discount the Estimated Share Price backwards by 10 years with your desired returns, we will need the "Present Value Calculator" or you can go to: http://www.moneychimp.com/calculator/present value calculator.htm

Step 5: Add Margin Of Safety

Lastly, add a margin of safety to the Target Buy Price to create a safety net for any errors.

You will notice that throughout the calculation process, there isn't any point of time we will use the current share price. The advice is not to peek at the current share price so that you do not get influenced by Mr Market. Rather, complete your calculations before looking what Mr Market is offering you. And if what Mr Market is offering, is below your target buy price, this is the time to take action.

TIMES TO SELL

Sean had no problem sleeping the night before. He was so mentally worn out that he collapsed into bed and slept like a dead log throughout. Mental exercise could drain you out as well.

For the whole of next week, he looked at businesses and asked if he knew enough to identify any possible durable competitive advantage. He then took those he felt had an advantage and started analysing with the criteria. And if they passed the criteria, he would calculate a target buy price. He would then take his analysis and show them to the old man and would ask for advice. The old man was always patient and but never answer any of Sean's questions directly. He felt that giving answers was akin to 'giving a man a fish and feeding him for a day. Instead, the old man would challenge Sean by asking him more questions and taught him 'how to fish'.

One day, Sean asked the old man, "Sir, I have a question. When we buy these great businesses from Mr Market at a sensible price, how long do we hold them?"

The old man, as usual, threw the question back at Sean, "Sonny, when you buy a great business at a sensible or great price, how long do you want to hold them?"

Sean knew the question was coming back to him, and he had learnt to prepare his own answers whenever he asked one. "I would hold them until it no longer makes business sense to hold them."

"That's a great answer sonny! In fact, my favourite holding period is... forever! Haha" the old man chuckled. "But there are times, I will still let these businesses go. Like what you mentioned, these are times when it no longer makes business sense to hold them. And in your opinion, when does it no longer makes businesses sense to hold great businesses after you buy them at a sensible price?"

Our favorite holding period is... forever

"I had been thinking about it Sir, and I have thought of 3 situations in which I will sell a great business.

The first situation is when the price of the share goes up to a point when it hits or overshoots my desired returns. Since I bought it at a price where it makes sense for me based on my desired returns, I will be waiting for Mr Market to price it so I can get my desired returns. Meaning to say, if within the first year, the share price goes up more than 20%, I will choose to sell it. If it is the second year, I will sell it if it rises more than 44% from the time I buy it."

The old man listened attentively and asked, "What are the other 2 situations?"

"The 2 situation is when there are better opportunities. If I can find another great business that can offer an even better rate of returns, I will sell off the business I am holding to buy the other one. This is of course done sticking the Rule Number 1 of not losing money. As long as I stick to the rule's boundaries, I will choose to jump ship because if I identify one that is giving me better returns and yet I do not switch, I am losing potential profits."

"And what will be the third situation where you will sell a great business?"

"The 3 situation, in which I will sell a great business, is when the business is in my opinion, no longer great. This happens if the business loses it durable competitive advantage when the business environment changes."

The old man remained silent for a moment and then he smiled and spoke up, "Sonny, you know what, it seems like you are ready to go fishing on your own already. You have learnt well and can now think for yourself."

Sean gave the old man a thumbs up, "You taught me well Sir."

For the rest of that fishing session, they fished and celebrated over a sumptuous meal of cokes and burgers. Both of them knew that they had

achieved something exceptional; they had taught an ordinary man how to fish in the stock market and this trait will last Sean for a lifetime.

Author's Note

Summary: When to Sell

As mentioned in this segment, the 3 situations to sell will be:

1) When price rise and hits or over shoot desired returns.

In calculating the target buy price, you would have set a desired return. So when the stock price rises to a point where you can get such returns and higher, you can choose to sell the share and realize your returns.

You will notice that if you set your returns to be 20%, your desired returns is hit when the share price rise 20% within a year from the time you buy. But if it will move on to the 2nd year, it will be 44% instead of just 40%. This is because we desired an annual *compounded* rate of 20%. So in the 2nd year, we will hit our desired returns of 20% per year if the share price increases by 44%.

2) When there are better opportunities

We love to buy great businesses but we do not fall in love with them. What Value Investors should look at is to get the highest rate of returns possible. Thus when there is a better opportunity, we can choose to sell our existing business and buy another one that is offering better returns. But do not mistake this for encouraging you to actively trade. There will be plenty of people out there who are not patient enough to wait for Mr Market to realize the value of the business they are holding and thus jump from one business to another in hope for a quick return. Remember that as Value Investors, we make our money on 'inactivity'. Every activity we take costs us in terms of

brokerage fees. While we can continue to look for better opportunities, we should be patient and stay on course.

3) When a great business loses its competitive advantage due to changes in business environment

The good news is that when we identify a great business with a durable competitive advantage, it does not sink that easily. If we have used Value Investing criteria stated to analyse the business, we will be able to understand the business enough to know when its durable competitive advantage is no longer relevant. For example, if we had invested in a type writer business years back, we would have been warned when we start seeing personal computers and printers starting to appear on everyone's desk. While the typewriter industry is wiped out, it did not happen overnight and Value Investors who understands the businesses we buy would have been able to react to it and stand at the side line if we are unsure of the business will survive.

Part 5: Application

TAKING ACTION

It had been a few months since Sean met the old man. He continued to fish with the old man whenever he could and the old man was always happy to see him. And Sean had begun to look at the stock market differently. Stocks were no longer merely numbers jumping up and down the screen; they were real world businesses that Mr Market offered every day.

His perspective of shopping changed as well. Whenever he walked along Main Street or spent money, he would take a pause to think if the business has a certain durable competitive advantage. He began to understand why the old man lived the way he did and why he said what he said. Once a person understood the concepts of Value Investing, the opportunities were abundant and everyday life became just a little more interesting.

After analysing businesses, he would determine a sensible price to buy them at before checking the price Mr Market was offering. Mr Market was still as psychotic and was unpredictable. It was no used trying to predict a psychotic. Instead, Sean let Mr Market serve him opportunities instead of allowing Mr Market's mood swings to affect his decisions.

Sean also shared what he learnt with his friends. What surprised him was that while everyone seemed interested to learn about Value Investing, most of them were still very affected by Mr Market and allowed the psychotic to

control their emotions and affect their decisions. He found out, like the old man said, that it was not easy to get people to understand that stocks are really businesses instead of merely numbers that bounce daily on a chart. He decided to continue his study on businesses and stay on course. Throughout the few months, he discovered great businesses that seemed to have durable competitive advantage and have showed through track records to be able to make consistent profits. He would then wait patiently for Mr Market to 'throw him a perfect pitch' and would buy at a sensible price. Below are some of the businesses he had identified.

THE PARTING

A year had passed since Sean met the old man at the jetty. His finances had improved and his portfolio grew. He began to wean off his dependence on the old man.

As the old man always told Sean, "My idea of a group decision is to look into the mirror. You have to make your own decisions." Sean was determined to be a confident value investor and made decisions on his own. So as the days went by, Sean became more caught up with his life and he visited the old man less often. He would drop by once in a while to bring his mentor his favourite coke and burger. The old man was always pleased to see him and they would talk for hours. They would occasionally have their little fishing competition, and the old man would use the rod instead of the net since there was no wager involved. They enjoyed each other's company and felt connected as fellow value investors who acted differently from most of the people in the market.

One day, Sean received a call from the old man's secretary, Linda. She explained that the old man had left to fish in other parts of the world and may not be coming back for some time. He had a farewell letter for Sean and she was tasked to pass it to him. Sean collected the letter from Linda at the jetty which had by now become a usual meeting place for him and the old man. It had become a place Sean had grown fond of as it was a place where his life

begun to turn around. It was also a place he would come for advice and personal reflections. After Linda left the jetty, Sean opened the letter and read:

Hey Sonny,

I always thought that I will never go offshore to show my stuff as I love this place and it has abundance of opportunities. Well, I will be gone for a while and based on my calculations the chances of us meeting again may not be predictably high. So, not being a person who knows how to handle farewells, I rather write you a letter and ask my secretary hand it to you.

Firstly, I would like to say that I enjoyed sharing my experience regarding investing with you. And I enjoyed fishing with you. Thank you for the cokes, the burgers and your attention. You are a teachable person.

You know, I am very suspicious of the person who is very good at one business; he also could be a good athlete or a good entertainer, who starts thinking he should tell the world how to behave on everything. For me to think that just because I made a lot of money, I am going to be better at giving advice on every subject, well that is just crazy. So this letter is not an advice to teach you how to live your life, it is merely just me sharing my experience. You want to learn from experience, but you want to learn from other people's experience when you can. So I am hoping that I can contribute to your learning by sharing my experience.

I want to warn you, not to confuse being rich with being successful.

Since young, I always knew I was going to be rich. I don't think I ever doubted it for a minute. I aimed to be a millionaire but I did not stop when I became one, so I went on to be a billionaire. And I don't have any problem with guilt about money.

You know, some people say that rich people are jerks. And of the billionaires I have known, money just brings out the basic traits in them. If they were jerks before they had money, they are simply jerks with a billion dollars. So if you know that you are a good person, why don't you go ahead and be a good person with a billion dollars?

But unfortunately very often money is treated as an extreme, either people condemn it or they used it as a benchmark for success. But to me, money cannot be the ultimate goal. There's nothing material I want very much. And I'm going to give virtually all of the money I made to charity when my wife and I die.

Money, to some extent, sometimes lets you be in more interesting environments. But it can't change how many people love you or how healthy you are.

Personally I define success as being loved by the people you hoped love you. And wouldn't it be great if we could buy love for \$1million? But the only way to be loved is to be lovable. You always get back more than you give away. If you don't give any, you won't get any. There is nobody I know who commands the love of others who doesn't feel like a success. And I can't imagine people who aren't loved feel very successful.

I had in my life, people whom I loved and people whom I felt I could have built a relationship and grew to love more. But I never look back. I just figure there is so much to look forward to that there is no sense thinking of what I might have done. It just doesn't make any difference. We can only live life forward.

So sonny, while you continue to live your live, find your passion, love the people you hope love you and do it today. There is no point waiting until all your finances are settled before you spend your time and money doing things you love and for the people you love. It would be like saving up sex for old age, wouldn't it.

I am a person who is lucky beyond my dreams. I have a job I love so much that I will be willing to pay substantial sums to have it. I have enjoyed wonderful families and great health and was equipped with the appropriate skill to get myself wealthy. And I am lucky and grateful to have spent time with you.

I know your life will be an exponentially fascinating one. Do go out there, enjoy yourself and pay it forward.

BILLIONAIRE

Many years later, Sean had lived a rich life. His investments had made him very rich and he made his friends very rich. He was a bit more extravagant than the old man; he drove a neat convertible and lived in a big beautiful house.

Even though he never saw or heard from the old man again, he would continue to fish at the jetty. He was however a bit more health cautious and ate freshly made sandwiches instead of burgers. He would sit and fish and enjoy the sea breeze and the good memories of how he met the old man. He could still vividly remember the time when money was such a huge worry to him. As he casted a line into the waters, he noticed a young lady standing at the edge of the jetty, looking worried. The wind blew and her hat flew towards the sea in his direction. He caught it just in time and stood to return the hat to the lady. She thanked him and he asked if she needed any help as she looked troubled. She needed a listening ear and was glad that a kind old stranger was willing to do that for her. She began to share her story of how she lost her mum's savings by trading the stock market after attending stock market courses.

"And you have broken investment rule #1!" Sean chuckled.

"Investment rule #1? Do you know how to invest? Will you teach me?" The young lady asked.

Sean smiled gen	tly and replied	"Only if you	are willing to	learn and	apply v	vhat
you learn"						

And the fishing continues...

Author's Parting Note

Thank you for reading Gone Fishing with Buffett and I do hope that this book had helped you in better understanding the stock market and Value Investing. And I also do hope you have enjoyed reading it as much as I have enjoyed writing it.

I had benefitted greatly financially, when my friend Jasper Bong introduced me the idea of Value Investing so I would like to thank him once more. I continued to learn from experienced Value Investors and never stopped reading books. I would also encourage you to continue to *invest* in the greatest asset of all, yourself! Do this by keeping your mind open to learning from people and from books Do however beware of who you learn from, because people love to give advice and act as if they are an expert in everything. But you will know by looking at their results. You will likely achieve similar results from people whom you accept advice from. So select the advice you accept as if you were selecting great businesses. Know what you are accepting and it must make sense.

Should you want to further your education in value investing, I will encourage you to read books by Mary Buffett and David Clark. They have personally benefited by the wisdom of Warren Buffett himself and that it the reason why I invited Mary Buffett to write the foreword of my book. It is my honour to have her to that and it is a way for me to honour her great works as I have personally learnt most of my investment methods from them.

The final advice I would like to give you is to actually use take what you have learnt from this book and put them into action. Because with actions, there will not be any results. You cannot compound your wealth merely by reading books. You got to actually invest. Legendary Investor, Sir John Templeton was once asked what was the best investing advice he would give anyone, he said, "Do it!". So this will be the same advice I am giving you, Do it!

Farewell and God bless you!

Sean Seah.

Hope you enjoy this book. Before you close it, there is another gift especially for you.

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