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DIVIDEND GROWTH INVESTING

HOW TO BUILD AN INCOME GENERATING STOCK PORTFOLIO

THOMAS CHUA

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INTRODUCTION

It is the beginning of the year 2020, the world got hit by a new strain of virus called Covid-19. It was first identified in Wuhan, China back in December 2019. The World Health Organisation ("WHO") then declared it a pandemic in March 2020. That is when all hell breaks loose in the global stock market including Malaysia.

But Malaysia was unique in the sense that we have our own political issues on top of the pandemic – double whammy! I still remember it was 16 March 2020 at 9.04am and I have just arrived at my workplace. While settling down, I was looking at the KLCI market crashing 110.38 points (equivalent to -7.78%). This was a big deal considering that KLCI market is not a big market like in the United States or Hong Kong. All my existing stock portfolio was in red. Fortunately, I did not hold much position during this time due to various reasons but the main one was the valuation in KLCI has always been expensive for the longest time.

If you are just starting out as an investor, we look at market valuation to identify whether a particular market has more undervalued stocks or overvalued stocks. A low valuation means the market has more undervalued stocks, thus more opportunities for you to pick up some stocks that has great businesses.

To gauge whether a particular market is expensive or cheap, investors tend to look at the historical price-to-earnings (“PE”) ratio of a particular market’s index. An index is a compilation of some blue-chip companies that met some criteria that the index has set forth – e.g. market capitalization of the company. In United States (“US”), there is the S&P 500 Index which is represented by 500 largest listed companies. In Malaysia, we have the FTSE Bursa Malaysia KLCI (more commonly known as KLCI Index or “KLCI”) which is represented by 30 largest listed companies in Bursa Malaysia by market capitalization.

Since these indices comprise of only the largest listed companies in that country, it can be a good proxy for investors to gauge the valuation for the whole stock market. Prior to the pandemic crash in KLCI, the fair PE ratio is at 16 times according to a Singapore research and brokerage firm – FSM One. However, KLCI has been trading at above this range most of the time from 2015 to 2019. The reason partly being the earnings were lacklustre for Malaysia companies. That’s why it leads to PE ratio inflated. If you’re looking for bargain, you might not find many in the Malaysia market during these periods.

My most profitable investment during these periods were only Padini Holdings Berhad and Perak Transit Berhad which generated a profit of 140% and 40% capital gain respectively. No other investments were made during these periods as I could not find any that is worth investing in. My investment track record was mediocre and so, I decided to change my method

of investing at the end of year 2019 and branch out to invest in the US market. My strategy is simple, dividend-growth for Malaysia and value-growth for US market. I also did some options trading for the US market to make some short-term income. I guess luck was on my side that the market crashes in year 2020 shortly after I decided to change my method of investing.

This allows me to invest into some great companies in the US as well as in Malaysia that is undervalued due to the crash – e.g. Adobe, Mastercard, Google, Wellcall, Sunway REIT, and Heineken, etc. At the end of year 2020, my US investment portfolio was up 70%. It was a great year for me and I think for everyone who has invested during the market crash as well. This just proves that you should not sell during the market crash. You should do the opposite instead.

My Malaysia dividend portfolio, on the other hand, was also up by 7.6% including the dividend income collected for the year. Not too bad considering the pandemic is yet to be resolved at this time and most of my holdings are recovery type of stocks. This means they will only do well when the economy starts to recover from the pandemic. You can view my dividend portfolio in my Instagram account. This is just the beginning of my dividend investing journey in Malaysia and I have a target to achieve a yearly dividend income equivalent to my yearly expenses in the next 5 years. I think this is achievable.

PART 1

THE BEST INVESTMENT MODEL FOR INVESTING IN MALAYSIA

CHAPTER 1

THE THREE MAIN MODELS OF STOCK INVESTING

"Risk comes from not knowing what you're doing"
~ Warren Buffett

If you look at the Forbes self-made billionaires, the top 10 industries that produce the most billionaires worldwide as of 2019[1] are:

1. Finance and Investments: 306 billionaires (14% worldwide total)

2. Fashion and Retail: 230 billionaires (11% of worldwide total)

3. Real Estate: 223 billionaires (10% of worldwide total)

4. Technology: 214 billionaires (10% of worldwide total)

5. Manufacturing: 188 billionaires (9% of worldwide total)

6. Diversified: 188 billionaires (9% of worldwide total)

7. Food and Beverage: 171 billionaires (8% of worldwide total)

8. Healthcare: 135 billionaires (6% of worldwide total)

9. Energy: 85 billionaires (4% of worldwide total)

10. Media and Entertainment: 71 billionaires (3% of worldwide total)

Noticed that most of them made their fortune through finance and investments? Forbes define this industry as making money for others which includes mutual funds and brokerage companies. In other words, it involves equity (or stock) investing.

This shows that equity investing can be lucrative if you know what you're doing. So how do these billionaires invest successfully? What is the one thing that is common among these investors (e.g. Warren Buffett, Peter Lynch, Ray Dalio, etc.)? They all have their own investment model (or principle). One that they consistently follow through regardless of any unforeseen circumstances.

Generally, there are two ways to stock investing. One is focusing on capital growth and the other strive to achieve a steady stream of dividend income. Each of these methods of investing has its own investment models or frameworks. Think of it like driving to your desired destination.

Let's say your desired destination is "A" and there are two roads you could take. The first one is a short but bumpy road and could potentially damage your car tyres. The second is smooth but needs a longer time to arrive. Both roads represent the methods of investing. The short and bumpy road is capital growth while the smooth but long road is dividend income. The car model that you drive represents the investment model.

Depending on which car model you choose, it will help to either smoothen that bumpy road or shorten the time taken to reach destination “A”.

Similarly, your choice of investment model will affect the time taken for you to achieve your financial goal. There are many investment models that we can learn when it comes to stock investing, but the three main ones are:

1. Deep value investing;
2. Value-growth investing; and
3. Dividend-growth investing.

The first two of the abovementioned investment models are for capital gains. The third one, as the name suggested, is for dividends. Let’s explore each of them.

1.1 Deep Value Investing

This is a classic value investing model created by Benjamin Graham who is also the mentor for Warren Buffett. By applying deep value investing, Warren Buffett was able to generate an annual compounded return of 29.5% between the year 1957 to 1969[2].

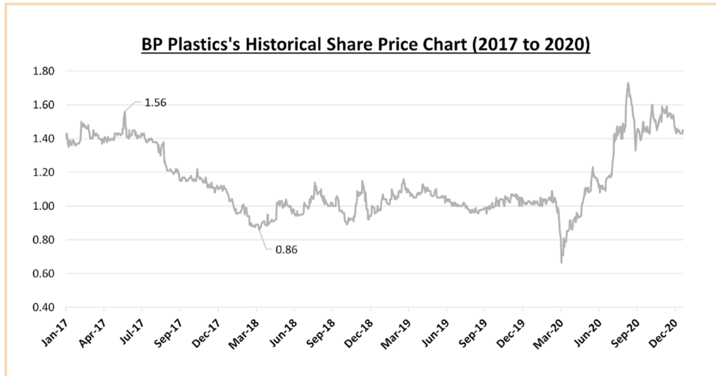
In a nutshell, deep value investing focuses on finding stocks that are priced significantly lower than its intrinsic value regardless of the quality aspects of the underlying business[3]. This is because the quality

of the business is often known by many and thus, already priced in. As such, the only time when a stock is significantly undervalued is when it faces a major setback that is temporary but viewed negatively by many investors.

BP Plastics Holding Bhd ("BPPLAS"), a company that engages in manufacturing and trading of plastic products to the garment and textile industries in Malaysia reported its 2017 fourth quarter results with a drop of 13.9% in earnings against its corresponding quarter. Consequently, its share price suffered a 14% dropped from RM1.00 per share to RM0.86 per share on 6th April 2018 – see *Chart 1.1.*

Its net assets (or net worth) per share (e.g. total assets less total liabilities divided by total number of outstanding shares) stood at RM0.88 per share which is equivalent to its share price. A look into its financial position, you would notice that the company has no borrowings and cash of RM44.2 million which accounts for 27% of the company's market capitalization. The company also has a history of paying a consistent dividend which at that point in time, it gives a dividend yield of 4.55%. In other words, it is cheap!

The share price has since recovered and hover around RM1.00 to RM1.16 per share in the year 2019 before the big crash in 2020 due to Covid-19 outbreaks which presented another deep-value opportunity.



(Source: Shareinvestor.com)

Chart 1.1: BP Plastics's Share Price Performance from 2017 to 2020

So instead of predicting the future growth of a company or how well the company will perform the next year, deep value investors are more interested in the current situation the company is facing (often a temporary crisis that leads to huge drop in share prices) and whether it can survive or not.

Looking back at BPPLAS, the company was only facing a temporary setback due to the increased in resin prices – one of its main raw materials – which leads to higher raw material costs incurred. You must know that resin is a type of commodity and its price will always fluctuate depending on the overall supply and demand. As such, it will not remain high all the time. Eventually, it will come back down and BPPLAS's raw material costs will lower once again.

What can we learn from this case study? Deep value investing strategy is suitable for companies that are facing temporary setbacks or sometimes near liquidation. Because these are the ones that investors (retail or institutional) will not look further into, which is why they are cheap!

It is also applicable to companies that have hidden assets such as land, properties, cash and investments, etc. The reason why they are cheap is because no one knows about the hidden assets and the management of the company have not unlock it.

1.2 Value-Growth Investing

The classic value investing strategy is buying something worth RM1.00 for RM0.50. If we combine it with growth investing strategy (which is a method of investing that focused only on stocks that has high growth potentials), it is known as value-growth investing.

This is a method which Warren Buffett adopts. In his letter to Berkshire Hathaway shareholders in 1992[4], he wrote:

"Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.

We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive."

In short, value-growth investing is about finding companies that have great growth potential and trades at reasonable price against its intrinsic value. Once these growth potential becomes reality, the company's intrinsic value will increase as well and its share price will eventually follow suit.

Value-growth investors usually take on an active approach in conducting in-depth researches and analysis towards the company's business, management and financial performances. This is to allow them to understand and predict whether the company will be able to grow further in the near future (typically, over 5 years). It's like playing a poker game as illustrated by

Peter Lynch, you would not have a better chance of winning if you bet without looking at your cards.

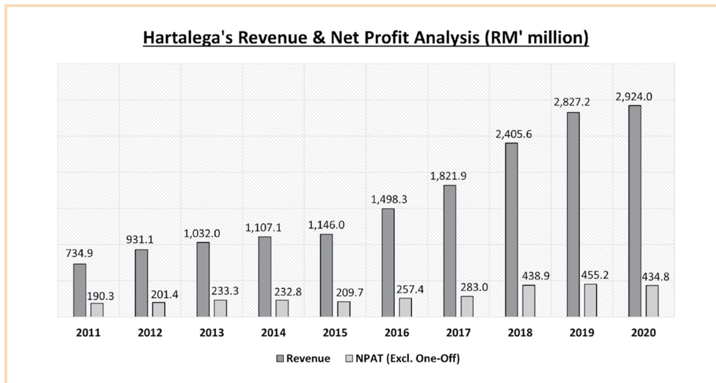
Often, you may find that this investment strategy is more suitable on relatively young companies, e.g. small to mid-cap companies. This is because they still have room to grow in terms of industry and the company itself.

For example, medical gloves made of latex aren't the best choice for medical practitioners as it could cause protein allergic reaction to those who are latex-sensitive. As a result, there is a switching momentum from latex to nitrile gloves and this benefited Hartalega Holdings Bhd ("Hartalega") who pioneered in the nitrile glove segment.

In 2010, 51% of Malaysia's export of rubber gloves to USA are synthetic rubber (predominantly, nitrile gloves)[5]. The nitrile glove segment was growing rapidly. As a result, Hartalega's revenue was growing at a compounded annual growth rate ("CAGR") of 16.6% from 2011 to 2020 – see Chart 1.2.

In addition, the company is also one of the lowest cost producer of nitrile glove. This is thanks to the management who invested millions in automating its production plant which increases the efficiency, thus lowering its unit cost as a result of economies of scale. It commanded a double-digit net profit margin consistently for the 5 years from 2015 to 2019 while most of its peers were only having a single digit net profit margin.

However, this have changed since year 2020 as the glove industry experience a global supply shortage due to the Covid-19 outbreak. As such, the average selling price of gloves had increased significantly leading to higher profit margin for all glove companies in Malaysia.



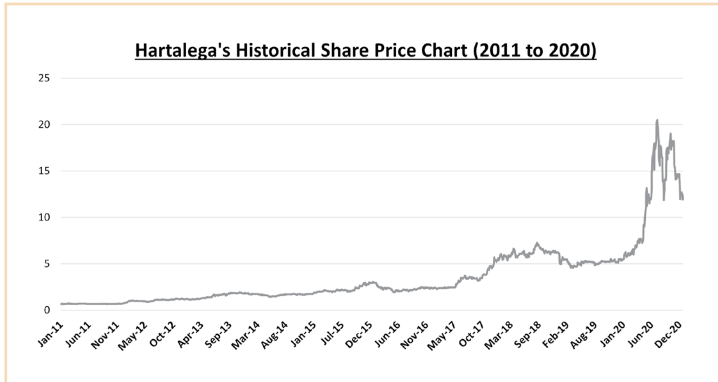
(Source: Shareinvestor.com)

Chart 1.1: BP Plastics's Share Price Performance from 2017 to 2020

Both the industry and its ability to reduce costs significantly had been Hartalega's main growth drivers. Back in 2011, Hartalega's average share price were trading at RM0.73 per share* with a price-to-earnings ratio of 13.1 times. Fast forward to now, its adjusted share price has grown to RM12.50 per share† as of January 2021. That is a compounded annual growth rate of 37.1% in capital.

* *This is based on adjusted share price for corporate exercise (e.g. bonus issues, share split, rights issues, etc).*

† *Adjusted share price is share prices adjusted for any bonus issue, share split and rights issue exercise, etc.*



(Source: Shareinvestor.com)

Chart 1.3: Hartalega's Share Price Performance from 2011 to 2020.

1.3 Dividend-Growth Investing

This is an investment strategy that focuses on investing in companies that pay growing dividends. Instead of looking at whether companies are able to grow its earnings, dividend-growth investors are interested in the consistency of companies paying growing dividend. In other words, they are investing for passive income.

Dividend-growth investing is the simplest approach as compared to the other two investment approach (e.g. deep-value investing and value-growth investing) that I have shared earlier and often require lesser time for decision making.

For example, the key thing about dividend-growth investing is the consistency of dividend payout. Any irregularity, dividend-growth investors would not look into it further.

Company	Dividend Per Share (Sen)										
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Jerasia Capital Berhad	-	-	1.00	3.00	-	-	-	-	-	1.00	-
Padini Holdings Berhad	2.80	4.50	4.00	6.00	8.00	11.50	10.00	11.50	11.50	11.50	11.50

(Source: Shareinvestor.com)

Table 1.4: Jerasia and Padini's 10-years historical dividend per share.

Table 1.4 shows two companies that are engaged in the retail of fashion wears. Jerasia Capital Berhad ("Jerasia") manages some of the well-known fashion brand like Mango and Terranova while Padini Holdings Berhad ("Padini") offers its products under its own brand name (e.g. Padini, Padini Authentics, Vincci, etc.).

By comparing the 10 years historical dividend payment of both Jerasia and Padini, you already know which one would make a good dividend paying company to invest in. It is obvious that Padini is the winner here as compared to Jerasia. This is because of its consistency in paying dividend even during the year 2009 where there was a global financial crisis due to sub-prime mortgages.

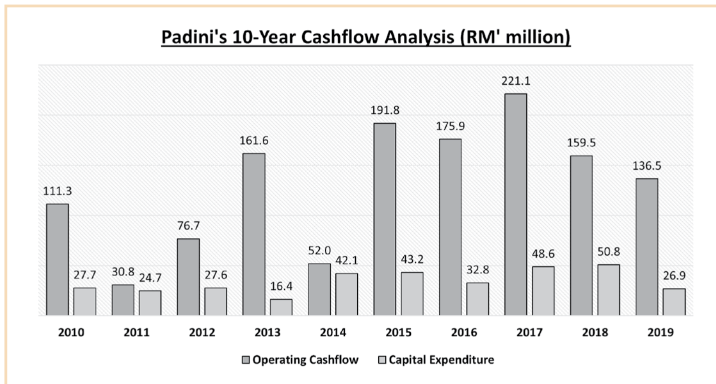
Just looking at the historical trend of the companies' dividend payments, you already know which one is worth your time to research further. This is why dividend-growth investing is simpler than deep-value and value-growth investing. As long as the company is able to consistently payout dividend, then you have found yourself a potential dividend stock.

Furthermore, there are 919 listed companies in Malaysia excluding Leap Market and only 458 of them pays dividend at as of July 2021 . Based on this, identifying a great dividend paying company have just become easier.

Your research work has been reduced by almost half. Isn't that good news? Instead of you focusing on all 919 listed companies, you would only need to focus on identifying a few great companies from these 458 listed ones. In later chapters, we will explore more on how to identify the best ones from these 458 listed companies.

You may find that this investment strategy is suitable for companies that are well established and usually, they are the mid to large market capitalization (above RM1 billion) type of companies. Simply because these companies have businesses that could generate cash flows to sustain its dividend payment.

Take Padini for example, its fashion retail business has been profitable over the past 10 years and this have led to the company's market capitalization growing from RM1.6 billion in the year 2009 to RM2.5 billion as of June 2019.

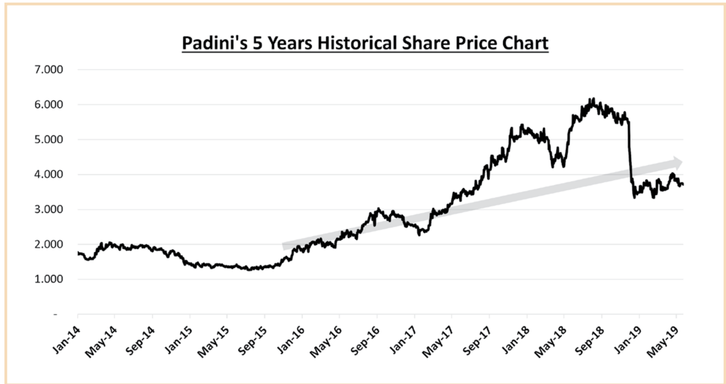


(Source: Shareinvestor.com)

Chart 1.5: Padini's cash flow from operation for the past 10 years.

In addition, the company has been generating positive cash flows of over RM100 million every year since 2015. This is why Padini is able to sustain its dividend payment of above RM0.10 per share.

If you invested in Padini during the year 2014 at an average share price of RM1.80 per share, your investment return based on dividend received stood at 6.4% per year. This is way better than the fixed deposit interest rate that you'll get from the bank.



(Source: Shareinvestor.com)

Chart 1.6: Padini's 5-year Share Price Performance

While 6.4% return does not seem to really get you excited, the beauty about dividend-growth investing is that you'll get the best of both worlds. Padini's share price in June 2019 were at RM3.76 per share, that's a 109% of capital gains. Include this to the dividend from the past 5 years' , your total return on investment would be approximately 140%.

1.4 Summary

In summary, there are two ways to make money from stock investing: capital gains and dividend income. Capital gains is the profit which investors make when they sell the shares at prices higher than its average investment costs. On the other hand, dividend income is the share of profit distributed by companies to its shareholders.

If you are looking for capital gains, you can adopt the deep-value approach which focuses on investing into companies that trades at a price significantly lower than its intrinsic value regardless of the quality aspects of the underlying business.

You can also adopt the value-growth investment model which focuses on investing into companies that have great growth potentials and trades at reasonable price against its intrinsic value.

If you are looking for dividend income, you can adopt the dividend-growth investment model which focuses on investing into companies that are able to pay sustainable dividend to its shareholders.

Each of these investment models is catered for specific types of companies. In the next chapter, we will explore the four stages of growth that companies will go through and which investment models are appropriate for these different stages of growth in a company.