HO KOK MUN

HOW TO MAKE MONEY FROM YOUR STOCK INVESTMENT EVEN IN A FALLING MARKET

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Author's Note

Seventeen years ago when this book was being prepared in late 2002, never did I expect that it would become an evergreen bestseller in Malaysia. Started with small pieces of hand-written notes that saw numerous changes before the draft manuscript was completed.

After communicating via e-mail, I met Adrian, who is the man behind Kanyin Publications, at Mont Kiara Coffee Bean in year 2003. We did not expect this first coffee discussion had led to many other rounds of discussion. Back then, we lived in the era when WhatsApp did not exist and therefore we often met face to face, followed by long hours of phone calls. Finally, just several days before Christmas 2004, the book hit the bookshelves in major bookstores in Malaysia.

Year 2019 marks the fifteen years of anniversary for this title. Fifteen years may not be long for some people. But, it is long enough for a book to prove its value. A readership of more than 35,000 has also spoken for its popularity. I am thrilled by my followers' support.

If I still have the chance, I may update the contents of this book 15 years later in year 2034. Till then, I hope you will like this book.

Ho Kok Mun

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WHY THIS BOOK

Most people want to do their day jobs well because they want recognition with bigger pay checks, greater security, higher status and brighter future. So, they work and try harder. You may be one of them. You have probably tried different ways of making money. Whether you are a fresh graduate, yuppie or middle-aged family man or retired person, you want an investment method which brings you maximum returns within the shortest period.

Stock investment could be one of those channels you have tried your luck on. However, how many times have you invested in stocks yourself after receiving tips from friends, reading news, watching Facebook live videos, attending seminars, or reading books and still did not get the returns you were aiming for? You spent months of effort and much money trying to make it work, but to no avail. Do not get me wrong. Some of your friends' tips may be genuine, books are good and seminars are very interesting. However, if those methods are not bringing you any return for whatever reason, then they are of no use to you no matter how good they claim to be. **If you have been in stock market for 15 years, yet not made at least 100% from your capital, it is time for you to read this book.**

This book outlines methods you can use to reap the most from stock market. Experience is the best teacher when dealing with money matters. I have walked through the swamp and hit the wall many times myself. I will help you understand my tried-and-tested methods. Remember this: Investing in stock market is not a risky venture; it becomes risky when it is done in ignorance, without any research and understanding of the subject. This book aims to provide stock investment know-how that you can understand and apply methods which suits your risk profile.

Contrary to the beliefs of many, **stock investment is not a gamble.** You should not buy stocks today hoping to make a million tomorrow. If that is your aim, try lottery instead. This book will show you how to get essential information you need to make a sound decision quickly. I am going to show you the good and the bad, and why I think they are so. Many will tell you what you should do but they will never tell you what you should not do and why. **I am going to explain to you the basics about stock investment and what is involved in the calculations so that you can know the intrinsic value and the fair value of a stock.** I am giving you a proven strategy. You simply go over a huge selection of stocks and decide what to buy, or not to buy and when to sell. **I will share with you both my mistakes and successes.** The truth is, I am not a full-time investor, but I am able to command good returns from stock investment. If you are working for others, you do not have to resign from your current job and be full time in stock market. I did not have to, and neither do you.

In year 2002, I started writing small pieces of hand-written notes. They have gone through changes before the manuscript finally made it to printer. The book reached bookstores, few days before Christmas in 2004. The first 2,000 copies were sold out within a short 2 months. Few reprints were done subsequently. It became a bestseller. I wrote the second book a year later. By year 2012, I have merged the first and second book together with minor updates. The sense of achievement I felt is something money cannot buy; I am **humbled by the fact that more than 35,000 copies of my books have been sold since 2004.** My book helped change many people's perception of stock investment. I am glad that I have contributed in this way. Nothing beats the feeling of knowing that my readers have benefited from the lessons I have learnt. The pointers I have put down in this book serve as a reminder to me of what I know and the strategies that lead to successful stock investment.

Starting in year 2017, I started to revise the book. I have spent close to 2 years updating the contents. At different stages of life, it is good for me to pen down new thoughts on stock investment. **I have added additional case studies, quoted more examples, included new calculations samples, enhanced stock selection criteria, elaborated on dividend topic, talked about annual report analysis, updated frequently asked questions (FAQ), added some statistics and many other new contents. In fact, I have written at least an additional 50% of new contents and revised all the chapters.**

In short, **this book is not a minor update, but a major revision. Year 2019 also marked the 15th anniversary milestone of this book.** Completing this book is the simplest way for me to thank all my readers and followers.

Whether you are new to stock investment or have been in the market for years, this book is the first step of your first mile for a better change. We get to where we are headed one step at a time, one mile at a time.

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HOW TO PICK GOOD UNDERVALUED STOCK

If you follow the guideline in this book, buy **a good stock at undervalued price** will give you 2 possible outcomes:

1. If you hold the good stock for 5 days or 5 months, you are unlikely to make a lot of money.

2. If you hold the good stock for more than 10 years, you will make money.

Three key takeaways: **buy a good stock, buy it at undervalued price and hold it for at least a decade.**

Now, using figures and calculations in this chapter, I will teach you how to identify a good stock at low price. When I first started learning about stock investment, I hardly understood the financial jargon used in market analysts' report. You might have come across those financial terms such as price-earnings ratio, earnings per share, net profit margin and debt to equity ratio in newspaper. However, you were too afraid to ask what they meant as you assumed there were common terms that everyone should have known. You might have also seen lots of charts done by technical chartists which you hardly understood. Do not get overly concerned about these charts and predictions. Stock picking is not about predictions. Predictions do not guarantee that your investments will yield positive returns.

What then, should you know?

- Basic mathematics, which you learnt in school, is good enough. Mathematics figures will remove emotion from you and help you to make better decision.

- Common business sense is equally important as well.

In this chapter, I will go through the process and calculation to estimate the intrinsic value as well as the fair value to identify a good undervalued stock.

4.1 Fundamental Analysis vs. Technical Analysis

Let me talk about the difference of fundamental and technical analysis. The approach I am using is based on fundamental analysis. This method attempts to measure the intrinsic value of a stock. Intrinsic value is the real value of a company. Overall economy, industry conditions, financial condition, and management of companies are studied as well in fundamental analysis. Conversely, technical analysis is another method of evaluating stock. It focuses on the analysis of statistics generated by market activity such as past prices and volumes based on charts. From these statistics, future trend is predicted with charts.

To further understand the key differences between fundamental approach and technical analysis, think of stock market as a residential property market: let's assume stocks are equivalent to houses for sale:

- Technical analysts will pay close attention to the crowd as a guide to what to buy. If they notice house buyers buying one type of house within a same area, technical analysts will buy, betting that the growing demand will push the price of those houses higher.

- Fundamental analysts on the other hand, move slowly through the market. Fundamental analysts might go one step further to check whether the location of the house is strategic, and they might evaluate the furnishing of a house, think about resell value of the house and ask agents or sellers lots of questions. Fundamental analysts will pore over specifications, scrutinise the developer's reputation and consult property market reports. The most important thing is fundamental analysts will put together data to come up with an intrinsic value that is independent of the current sale price. If the sale price is less than the calculated intrinsic value, fundamentalists will buy it. Otherwise, they will continue to look for better houses in other areas.

No doubt, performing a fundamental analysis requires time and hard work. However, let me assure you, the experience you gain as well as the monetary returns are worth all the effort. Buying houses based on intrinsic value and holding it over the long term protects you from the risk of day-to-day property market flux. The same concept applies in stock investment.

When you buy a stock, you are buying a proportional share of a business. To figure out how much the stock is worth, you should determine how much the business is worth. You do this by assessing the company's financial health in terms of per-share value. This is known as "fundamental analysis" which I have been preaching. You take into consideration only fundamental variables that are directly related to the company itself, such as its return on equity (ROE), earnings per share (EPS) growth rate, debt equity ratio, net profit margin and price-earnings ratio (P/E), which I will explain all these terms later.

Although analysing a business might seem like a straightforward activity, there are many approaches to fundamental analysis. Most investors or analysts come up with approaches that are a mixture of different methods. Many of the distinctions are more academic inventions than actual practical differences. What I preach is the practical approach, not just paper theory.

Some people have two major arguments against fundamental analysis.

1. First, they believe that fundamental analysis has no advantage because the information which is used for analysis, is available in publicly traded markets. In other words, everyone has access and knows it.

2. Second, it is up to the person considering the fundamental information to interpret its significance. These critics argue that fundamental analysis is unscientific. It is difficult to get a clear picture of a company's value when there are so many qualitative factors such as company management and competitive advantage.

For point 1, yes, everyone can access publicly information such as annual report but not everyone studies it. Even if the same report, investors may understand it differently and therefore take different action. As for point 2, yes, we must consider management and competitive advantage of a company. Interpreting that information is subject to one's experience and each individual may comprehend it differently. If these critics claim fundamental analysis is not good, what other method is available? Some analysts have created a set of tools to study market trends. They study the history of a company's prices or indices to predict future market behaviour at the macro or micro levels. They may use mathematical and probabilistic methods to understand the trend to predict the future stock price. They believe price and volume action on the charts contain hidden messages about supply and demand. They call themselves "technical analysts." They believe that charts provide insight into the psychology surrounding a stock.

Such analysts prefer to use charts to time their investments. Pure chartists rarely look at any of the qualitative data about a company (for example, its management team or the industry that it is in). They try to predict future price of a stock by looking at the history of its prices and other trading variables. The most important indicators seem to be specific chart formations (figure charts, logarithmic charts or Japanese candlesticks) that show price movement and trading volume. Technical analysts may use advanced technology including artificial intelligence with data mining capability to predict price movements.

Using only price movement data may make an overvalued company appear cheap just because its price has fallen for consecutive 5 days. In fact, most of the statistical work to determine whether chart patterns are predictive has been inconclusive until now. Much of the faith in technical analysis does not have any kind of long-term statistical evidence to prove its success. Some technical analysts claimed that their methods of using charts have worked well. They may be lucky to predict the short-term trend of a stock price, but to be able to know the exact price trend consistently for medium or long term, I doubt so. No one has come out with such perfect forecasting tool.

I agree with the point that market sentiment is the key factor to affect stock prices, but I am sceptical about the charting approach. For things which cannot be explained by science or calculation, technical analysis and predictive analysis may be used. For instance, after doing 10 years of survey, I may have an interesting conclusion: 25% of the male students, who study in University ABC like eating dark chocolate. **No science behind the figure. No logic.** For the next batch of male student, I have that 10-year record to support my prediction. Stock investment is about business investment. Hence, the basic of business applies. It is about profit. You get the figures from annual report. You know the management decision from the news announcement. **Using technical analysis to predict the stock price without understanding its business**

does not do justice to any company. If stock price can be solved with only chart, those who practiced it would be wealthy beyond their wildest dreams quite easily and yet none of them are, at least not right now. I do not use technical analysis because I do not include behavioural variables in my analysis. I focus on company's business to determine whether stock should be bought or sold. I care less about whether others will buy or sell the stock. As long as my target company falls below my target price, I will invest.

Like swimming, some swimmers use front crawl, breast stroke or the butterfly stroke. Some mix and match. In stock market, I realise some combine both fundamental and technical analysis together. This group of buyers may occasionally do better than pure chartist. My only concern is that they sometimes make emotional decisions using pure chartist method by ignoring the company fundamental, just because they want to convince themselves with a good reason to buy or sell. Few even go one step further, not only they study charts and fundamental, they also listen to tips. I highly doubt about the success of this group. The moment someone gets any tips, he tends to make decision based on emotion. **Therefore, using hybrid method may not necessary help. It may make things more complicated.** Stock investment methods, which are more difficult to understand, may not necessarily increase the chance of success.

It is up to you. As long as you can beat the opponents, you use the method you prefer. No right or wrong about it. The method that brings the highest returns consistently over a long period of time is the winner.. **Fundamental analysis has worked well for me, I am still using it today and my readers and students can vouched for that.**

4.2 Learning Financial Jargons

In stock market, you must know that you are not buying sugar, salt or some other grocery item. You are using your hard-earned money to buy a company business because you want to be one of its shareholders. However, which stock is good and which one is not? What price should you pay? I will cover these topics.

Though you do not have to be overly concerned about technical jargons and the numbers you come across in the reviews of analysts, you need to know these terms:

1. Profit
2. Return of equity (ROE)
3. Earnings per share growth rate (EPS GR)
4. Debt to equity ratio (D/E)
5. Net profit margin

Other values, which also should be considered, include:

1. Dividends
2. Price to earnings ratio (P/E)

These financial terms may seem technical but rest assured that I will go through each of them, one by one. You will use some of this information to calculate intrinsic and fair value of stocks. Then, by comparing this value with the current price of a stock, you will know whether the stock price justifies your purchase decision. If the value does not make sense, no matter how affordable you think the stock is and no matter how much cash you may have in hand, forget it. It is better to keep your money for undervalued stock.

First and foremost, please do not only look at a single year result. Instead, look at historical records, at least over the last 10 years. Doing so help you investing only in a company with a proven track record. If historical business performance shows that the company has been consistent over those years, then you are in safer water. **Consistency reduces risk.** If a company has shown 10% growth rate yearly over 10 years, it will not suddenly generate 50% growth rate. In fact, in reality, the tendency for growth rate to slow down is higher.

4.3 Profit

If you happen to be in a discussion with your friends about any stock, ask a simple question, "Has the company been making profit consistently for the past 10 years?" If your friends look at each other, or stare at you without giving you a firm answer, unlikely they know. Sad but true, many talk about stock price without knowing whether the company is earning or losing money.

A business must have profit to thrive. If the business has been losing money, its stock price will not go up forever. Without profit, the company cannot afford to pay salary to its employees and suppliers. It cannot distribute dividend to its shareholders. It cannot expand its business. It cannot invest in research and development. It cannot even get a loan from any bank. So without profit, the company cannot survive. Imagine every dollar you put into the company would result in a loss. It is a matter of time shareholders dump the stock. Shareholders will want to sell the stock yet no one wants to buy it. When supply is more than demand, share price goes down.

Use profit as the first guidance before you go deep into other financial details. **Company must generate profit.** You should invest only in stock with business which generates profit.

4.4 Going for ROE

Normally, analysts measure a company's yearly performance by looking at the earnings per share (EPS). EPS, as the name implies, is the earnings gained for every share. However, because most companies retain a portion of the previous year's earnings as a way of increasing equity, there is no real reason to get excited about EPS alone. On the balance sheet, equity refers to the value of the funds contributed by the owners (the shareholders) plus the retained earnings (or losses). There is nothing spectacular about a company that increases EPS by 10% if at the same time, it is growing its equity base by 10%. Return on equity (ROE) helps you to identify the gem.

Let's look at an example:

- Assuming 2 business owners, Mary and John. Both are given $10 as capital to start off with.

- At the end of first year, both John and Mary acquired earnings of $2 each. Mary distributed the $2 earnings to shareholders whereas John added $2 to his original capital of $10 to get an equity base of $12.

- In the second year, Mary raked in a profit of $2 from her original $10 whereas John also managed to get $2 from his $12.

- In this case, Mary is better at increasing the shareholders' returns on investment. As an investor, you should pick Mary instead of John. Why is it so? With only $10 (which is $2 less than John), Mary got $2 (20% return). Despite John got also $2, but his return is only 16.7% from his $12 capital, not as good as Mary in terms of percentage.

Now, let's look at some equations. You need to know what shareholder equity is. Shareholder equity is equal to total assets minus total liabilities. It is what the shareholders "own".

Shareholder Equity = Total Assets – Total Liabilities

- *Asset* is any item that has tangible value and can be sold or exchanged for something else that possesses value. Some examples are cash, accounts receivable, inventory, real estate or securities.

- *Liability* is any debt or obligation a company, person or business may have. It is something that takes away value. For example, unpaid mortgage or outstanding money owed to suppliers is considered a liability. Liability could be "short term" or "long term" liability.

Shareholders' equity is the company's total assets minus its total liabilities. Let's use another example. You bought a house at a price of $200,000. You invested $50,000 of your own money and borrowed $150,000 from the bank. The $50,000 you invested in the house is your equity in the property. Your asset is the $200,000 house. Your liability is $150,000 loan from the bank.

When you rent your house out, the amount of money you earn from the rental, after paying your expenses, mortgage and taxes, would be your net profit. If you rented your house out for $15,000 a year and had $10,000 in total expenditures, then you would be earning $5,000 as net profit a year.

Now let's understand what ROE is.

$$\text{Returns on Equity (ROE)} = \frac{\textit{Net Profit}}{\textit{Shareholder's Equity}}$$

When calculating the return on your equity, you would take your \$5,000 in profit and divide it by your \$50,000 in shareholders' equity. This equates to a 10% return on equity (\$5,000 ÷ \$50,000 = 10%).

Likewise, if you owned a business that had \$10 million in assets and \$4 million in liabilities, the business would have shareholders' equity of \$10 million - \$4 million = \$6 million. If the company net profit is \$1.5 million, the business's return on shareholders' equity would be 25% (\$1.5 million ÷ \$6 million = 25%).

$$\text{Alternatively, Returns on Equity (ROE)} = \frac{\textit{Net Profit}}{\dfrac{\textit{Ending Equity} + \textit{Beginning Equity}}{2}}$$

If a company has a net income of \$10 million, started the year with \$40 million in shareholder equity, and finished with \$50 million, its ROE would be 22%.

$$\text{ROE} = \frac{\textit{Net Profit}}{\dfrac{(\textit{Beginning Equity} + \textit{Ending Equity})}{2}}$$

$$= \frac{\textit{\$10 million}}{(\textit{\$40 million} + \textit{\$50 million})/2}$$

$$= 0.22 \text{ or } 22\%$$

In other words, management obtained 22% returns on the resources which shareholders provided to them to generate profits with.

To help you better understand ROE should be taken seriously, let's look at a simple example:

> Company A has a beginning equity of $100 million. It invests in a business that generates only $6 million besides earning a total of $4 million from the fixed deposit (time deposit) interest given by bank. So, its earnings for the year are $10 million, giving it a total of $110 million in equity at year end.

$$\text{ROE} = \frac{\textit{Net Profit}}{\dfrac{(\textit{Beginning Equity} + \textit{Ending Equity})}{2}}$$

$$= \frac{\$\,10 \textit{ million}}{(\$100 \textit{ million} + \$110 \textit{ million})/2}$$

$$= 0.095 \text{ or } 9.5\%$$

> In the following year, let's assume that this company shuts down its business and deposits its income ($110 million) in the bank to earn interest. At year end, let's say it has earned $5 million in interest.

$$\text{ROE} = \frac{\textit{Net Profit}}{\dfrac{(\textit{Beginning Equity} + \textit{Ending Equity})}{2}}$$

$$= \frac{\textit{\$5 million}}{(\textit{\$110 million} + \textit{\$115 million})/2}$$

$$= 0.044 \text{ or } 4.4\%$$

As you may have noticed, though the company is still making money from its equity, while only getting interest from a fixed deposit (time deposit) in the bank, the ROE has been reduced substantially from 9.5% to a mere 4.4%. I hope this shows you why I emphasise the importance of ROE. A high ROE is important. The higher a company's ROE compared to that of its peers in the same industry, the better the company is. You do not want a company which does nothing but only get time deposit interest from the bank.

ROE indicates the amount of returns a company is generating on the owners' investment. ROE is also referred to as the stockholders' returns on investment. Knowing the ROE will help you ignore exaggerated comments made by CEOs in their annual reports, such as that they have "achieved outstanding record earnings" or "attained good earnings." Achieving earnings each year for a cash rich company is an easy task. Why? As you have seen in the previous example, if management deposits the money in a bank to yield an interest of 4 % annually, they would be able to report "earnings" because of the interest earned. Are shareholders better off? The answer is no.

I consider ROE as an important ratio to evaluate how well the management is making use of the assets of the company in generating returns for its shareholders. ROE considers retained earnings from previous years. It tells investors how efficiently their capital is being reinvested. Remember, the goal of every business is to maximise returns on investment. Every investment must make the best use of shareholders' money. If a company grows, you should expect a higher ROE. The higher the ROE, the higher the rate the company is increasing its shareholders' equity, which is supposed to lead to an equal increase in stock price. Thus, ROE is important.

One point to remember, as I mentioned earlier, do not look at ROE for a single year. Averaging ROE over the past 10 years will give you a better idea of a company's historical growth. If I find a company that generates not only 15% ROE, but is also to maintain it consistently, I will shortlist it.

Why 15% and not 5%? Firstly, there is inflation. Inflation is the overall rise in prices of goods and services resulting in a decrease in purchasing power. For example, suppose this year you buy a can of Coke for $1 and the yearly inflation is 5%. Theoretically, 5% inflation means that next year, the drink will cost 5% more or, $1.05. So, if your income does not increase by at least the rate of inflation, you cannot afford to buy as many cans of Coke as you used to be able to. Hence, your investment must beat the inflation rate. In addition to this, you must beat the interest rate of fixed deposits offered by the bank.

Because investing in stocks means taking a risk, you should compensate for having to take this risk by going for more than you can get from putting your money as fixed deposit. I believe that 15% is a fair figure. If you cannot get 15%, 10% is better than 5%. The increase of 15% in ROE may not guarantee that stock price will increase by 15% or more as the performance of stocks depends on market sentiment. However, over the long term, stock price should go up in parallel to the fundamental value of the stock. If you think 15% is too low, you may aim for a higher percentage, say, 20% ROE, although it is difficult to find a company that could maintain such high growth rate consistently over 10 years.

In order to have high ROE, following are few of the conditions:

1. The company must be good at growing its business with high earnings.

2. The company pays dividends. Dividend payout reduces the equity of shareholders and enables the company easier to post high ROE. Remember the Mary and John example? If Mary keeps distributing yearly earning as dividend, it may not be good even though it looks good on ROE figure. I will prefer to get Mary to use whatever she has earned to make more money for me. Mary could get 20% of return from the shareholders' fund. Mary gained $2 from $10 making it to be $12; next, another 20% from $12 which made it to be $14.4; on third year, another 20% from $14.4 making it to be $17.28. As you can see, instead of taking the money out as dividend, we keep the money for Mary to continue to make 20% from the fund each year. Company, which is growing at a rapid rate, normally does not pay high dividends. I will discuss about dividend later.

3. Company may manipulate ROE through share buybacks. It uses cash to buy back its shares and therefore reduces outstanding shares as well as the assets on the balance sheet (because cash is an asset). Thus, ROE has gone up because there is less outstanding equity. Unless it buys its shares consistently over the years to jack up the ROE, the average ROE (10 years record), which I have suggested, will be helpful for you to judge if the company is manipulating the ROE figure just to attract investors' attention. Depending on the approach, share buyback may be good for investors. If the stocks are good, and there are more buyers than

sellers, stock prices will go up. I will discuss share buyback in detail later too.

4. Alternatively, the company manipulates ROE with restructuring charges or sales of assets for one-time gain. This is what I label as an "artificial boost" to ROE. So, be aware of this trick. Again, a look at the historical records will help you identify this manipulation.

Following are some of the Bursa Malaysia main board companies with high ROE between 1998 and 2002 when I first published my book in 2004. I then compiled their ROE between 2008 and 2017:

Companies	Average Yearly ROE (1998-2002)	Average Yearly ROE (2008-2017)
BAT	120.7%	164.3%
Nestle	50.2%	71.86%
Dialog	35.9%	18.17%
Carlsberg	30.8%	44.01%
Guinness (Heineken)	30.0%	51.81%
Unisem	28.1%	6.42%
Berjaya Sports Toto	27.6%	68.73%
Amway	25.7%	41.1%
Eng Teknologi	23.7%	Delisted
JT International	21.7%	Delisted
Mitrajaya	21.2%	13.56%
PETRONAS Dagangan	20.7%	15.02%
TSH Resources	20.4%	9.6%
MOX	20.2%	Delisted
Powertek	20.2%	Delisted
Malakoff	20.2%	7.43% (delisted in 2007 and relisted in 2015)
Tanjong	20.1%	Delisted