



**KEEP**

**INVESTMENT**

**SIMPLE**

**AND**

**STUPID**

**Jonathan Quek & Benny Lee**

**Kanyin®**  
PUBLICATIONS

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# CHAPTER 1

## The Truth About Investing

When I first joined the financial industry, I was an enthusiastic learner. I have gone beyond simply attending trainings provided by my company. I have also invested into various personal financial planning courses in my personal time and at my own expense. In most courses, I've been taught to give traditional advice to my clients:

- "High risk equates to high returns"
- "Lower your risk by diversifying into a portfolio of funds"
- "Lower your risk by investing long term"
- "Let the professional fund managers manage your investments"

Then in 2010, I came across an interesting story about Lusha of Russia. For the very first time, the traditional advice that have been taught to me all this while was challenged. This is how the true story about Lusha goes.

### The Story of Lusha

Lusha is a chimpanzee who stars in a circus act in Moscow, Russia.

She was given 30 cubes representing different companies and asked, "Lusha, where would you like to invest your money this year?" Lusha chose eight of the cubes and her trainer, Svetlana Maksimova, used the selections to invest one million Russian rubles (about USD31,236).

Lusha's top picks included banks whose shares soon rose a stunning 600% and mining companies that were up 150%. Lusha split her investments between state-owned companies and private companies. Her portfolio almost tripled in value.

In fact, Lusha has outperformed 94% of the country's investment funds!

The fact that Lusha had no prior experience in investing and what's more – a chimpanzee – yet it was able to achieve such profits in investment is remarkable!

Investment bankers are paid a fortune for their ability to make complex decisions about where to invest millions of dollars every single day. Lusha's investment success made all serious analysts look like clowns.

I started to understand how successful investors really think. When I talk to successful investors, the lessons taught seemed so different:

- "Low financial education equates to high risk"
- "Ignorance on diversification equates to 'de-diversification'"
- "Diversification among bonds, stocks and mutual

funds only means diversification among paper assets"  
 "Stop letting the fund managers make fun of your money"

After exposing myself to investors who made millions of dollars, I realised that I must go through a new level of learning. I had to unlearn whatever I have learnt and relearn the spirit of successful investors. My financial education has truly begun.

I sold off all my unit trusts and went to the extent of putting a full stop to my career in financial planning. I was still enthusiastic about personal financial planning. I just could not agree with some of the things that financial planners have been doing. Most of them are so eager to sell their financial products yet they refused to put even a single cent of their own in it. To me, that's simply immoral.

### Sex and party for potential insurance clients

Mon, Mar 22, 2010  
 The Star/Asia News Network

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SOME insurance companies in Johor are recruiting female agents to have sex with potential customers, Guang Ming Daily re-reported.

The companies also arranged for the agents to party with the would-be clients at nightclubs and karaoke outlets.

Sources told the newspaper that the female agents were recruited among divorcees, single mothers or those helping their boyfriends repay debts.

"These are women who will do anything for money," the sources said, adding that the agents went after middle-aged small entrepreneurs who were not very highly educated.

Agents who failed to "hit" their targets would be punished by having to "showcase" themselves in adult diapers or lingerie.

They were also forced to pay fines of between RM1,000 and RM3,000 to their company.

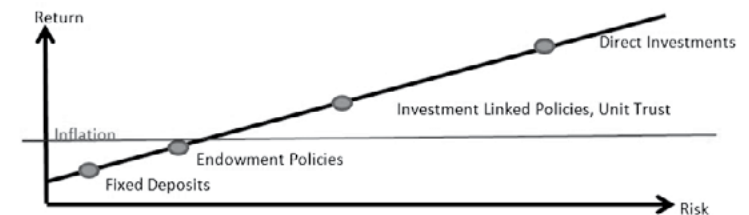


(Figure 1: Sex and party for potential insurance clients, a news feature taken from The Star Asia News Network, Mar 22, 2010)

Unfortunately, there are many people out there who suffer losses because of their belief in these myths of investing. Some have yet to really understand what's going on. So, in this chapter, I would like to expose the 4 Deadly Myths of Investing:

### Myth No. 1 – High risk equates to high returns. Low risk equates to low returns.

For years, financial planners and bankers have been preaching low risk, low returns; high risk, high returns. Just a few months back, I was having a conversation with a financial planner who shared that I'm a high-risk investor by looking at my investment portfolio. I asked him why, and this is what he showed.



In his exact words, "When you invest in gold and silver, you are going into direct investments. That's high risk! In order for us to lower your risk, you must engage professionals to help you structure a balanced portfolio. The fact about investments has always been high risk, high returns; low risk, low returns."

**Reality:** Today, whenever a financial planner tells me that, I ask them if they've ever seen a country going bankrupt. Most of them answer a resounding, "No."

There are many cases of countries going bankrupt whether

you like it or not. Even some of the strongest countries such as Italy, Spain, Japan and the US are on the verge of bankruptcy.

Yes, your fixed deposit guarantees return, albeit low returns, but bear in mind that the money in the bank is not necessarily safe. It is because, when you put money in the bank, it is not actually a deposit but rather you've become an unsecured creditor of the bank.

The key to having low risk investments is by not putting your money in the bank. Best course of action? Increase your financial intelligence. Just think about it. Imagine giving my car keys to someone who has no driving license and doesn't know how to drive. Is that high risk to both my car and the driver? Absolutely! However, is it high risk for me to drive my own car? Of course not! Because I've been driving it all day and night! I know very well what to do and what not to do.

In today's world, ignorance is no longer bliss. Ignorance is pain. When you have low financial education, it is going to be high risk regardless of where you put your money. The fact is this – it isn't gold, silver, real estate or stocks nor is it shares per se that makes you rich. It is what you know about them that will make you rich.

Ultimately, it is not about high risk investments creating high risks. It is ignorance that creates high risk. Knowledge, on the other hand, creates high returns.

### **Myth No.2 – Diversification or 'De-worsification'**

Unit trust agents simply love preaching "Don't put all your eggs in one basket." With this old saying, they start to sell their unit trust products that provide investors with the opportunity to pool their resources together for the purchase

of a diversified portfolio of financial instruments. By pooling your funds, you gain the capacity to spread your investments around so that you have a variety of assets in your portfolio. Spreading your money within and across different asset sectors may reduce your risk compared to holding only one or two investments.

**Reality:** Whenever financial planners or unit trust agents tell me that I must diversify using mutual funds, I enjoy shocking them by saying that I don't believe in diversification. This might be a bit harsh as I really should have said that I didn't believe in over-diversification. I believe in concentrating positions into a few assets.

Warren Buffett is widely quoted for saying, "Diversification is protection against ignorance." I'll admit, that too sounds pretty harsh. But what I believe Buffett was trying to say was that you diversify when you are not sufficiently confident to bet on which asset (or asset class) that would do well and which would not.

### **Myth No.3 – Never Put All Your Eggs into One Basket**

If there is anything to be learned from the mess that is happening in Europe and the US, it is the fact that no paper assets can be guaranteed. This includes all the long-term savings plans, mutual funds, bonds, investment-linked policies and fixed deposits.

For years, financial planners and bankers have been teaching their clients never to put all eggs into one basket. They teach their customers to diversify into different products so that if one stock or unit trust takes a hit, there are still others that will go up. The more spread out you are, the more protected you are from losing money. Unfortunately, that's not true at all!

**Reality:** Whether you have diversified into long-term savings plans, mutual funds, bonds, investment-linked policies or even fixed deposits, all your investments are still paper assets.

In the event that the financial system in a country is disrupted, all these paper assets are in fact linked to the same fragile economy. When the monetary system fails, it won't make a difference whether you're invested into CIMB, Public Bank or Maybank because they all have the same investment model. If there is a crash in the property market, it doesn't really matter if you're investment into condominiums, bungalows or shop-houses. Your property portfolio may look diversified, but they are in fact the same asset class.

A real investor is one who understands the concept of true diversification. I am no financial planner, but when I invest, I invest across different asset classes such as real estate, commodities (like gold & silver), business assets (like my companies) and yes, paper assets like stocks and shares. True diversification requires you to understand the economic lifecycle.

#### Myth No.4 – Invest Long Term

Financial planners have been preaching that stocks over the long run will always go up, so just buy and hold. This is so true yet misleading as well. It is true because the world's biggest and most established stock index, the US Dow Jones Industrial Index, has been going up for the past 100 years and has averaged at 8-9% return every year.

**Reality:** Imagine that you're a citizen of one of the many riches nations in the world. At the age of 25, you started on your retirement planning and faithfully invested your money in the local stock market in hopes that at the point of your

retirement, you would have at least doubled your money with a nice retirement nest.

25 years later at the age of 50, you reach your retirement age and you review your investment portfolio only to be shocked to see that your retirement portfolio hasn't really grown at all. In fact, you have lost money. The country in question is none other than Japan, one of the richest and most prosperous countries in the world.

Seriously, I do not know what your definition of long term is but in my humble opinion, 25 years is very long term. If you cannot make money after 25 years of investment in the stock market, then the conventional wisdom of buying and holding for the long term should not be deemed as the universal trust in the first place.

#### Myth No.5 – Believing in Predicting the Future

One month before the October 1987 stock market crash, George Soros appeared on the cover for Fortune magazine. He said, "The [American] stocks have moved up, up and away from the fundamental measures of value does not mean they must tumble. Just because the market is overvalued does not mean it is not sustainable. If you want to know how much more overvalued American stocks can become, just look at Japan."

George Soros, one of the most successful investors in the world, was bullish on American stocks. He felt that there was a crash coming in Japan. He then repeated this outlook in an article in Financial Times, October 14th 1987.

A week later, George Soros's Quantum Fund lost over USD350 million as the US market crashed instead of the Japanese market. What he profited over a year was wiped out in just a few days.

**Reality:** George Soros admitted later on, “My financial success stands in stark contrast with my ability to forecast events.”

If someone who can make accurate market predictions consistently actually exists, the world's media would relentlessly hunt him or her down. Media ‘gurus’ make their money from talking about investments, selling their advice on the next big thing. That is why successful investors who make actual money from investing rarely talk about what they do or what their outlook is on the market. The person who discovers how to turn lead into gold isn't going to give you the secret for USD100 a year.

### What's Next?

By now, I believe that you're probably wondering that if all these traditional advices that bankers and financial planners have been advocating don't actually work, what works then?

Well, truth to be told, some of the strategies do work but they only work under certain conditions and market situations. The reason why I'm pointing it out is to show you that these are the mindsets and strategies implemented by 80% of investors worldwide! Yes, I'm talking about the Pareto principle, the 80/20 rule!

While 80% of the people in this world believe in job security, the other 20% believe in financial freedom. Again, the 20% are the richest people on Earth.

While 80% of the people in the world believe in living a simple & contented life, the other 20% (again, who are also the richest people on Earth) believe in living their dreams.

While 80% of the people in this world believe in handing

their money to a financial planner or banker, the other 20% (AGAIN, who are also the richest people on Earth) believe that there is no one else better in managing their money than themselves.

That's why 20% of the people in this world in fact own 80% of the wealth globally!

Therefore, in order for you to understand how to make money, you must first understand why most people lose money.

### Why Do People Lose Money and Why They Will Continue Losing More Money

#### *Loser Mindset No.1 – Buy on Emotion, Sell on Logic*

Over the years, I've met many investors whom have little to no confidence in their investment portfolios. When probed further, I realised that most of them buy based on their gut feeling and relied little on facts and figures. They have little to no knowledge on how value is created to make profits on their investments. They base their investment purchases on pure emotions and not by logic. They buy and sell based on the opinion and advice of friends and family (who are usually poor investors themselves). In short, their decisions are usually driven by fear and greed.

#### *Loser Mindset No.2 – “It's Not My Fault!”*

In year 2012, Bank Negara Malaysia (the Central Bank of Malaysia) raided several ‘Innovative Gold Trading Firms’ in Malaysia. A Facebook Group was even set up to bring together a ‘Supporters Group’. When I saw some of their comments, I understood clearly why these people lose money.

- "If this is a scam company, why would the former Prime Minister, Tun Dr. Mahathir, officiate their company's event?"
- "Bank Negara Malaysia does not know what they are doing when they raid the most innovative gold trading company in the world!"
- "We are victims of the government's stupidity!"
- "Why is the Deputy Finance Minister lying?"

As you can see, most average investors hate to admit that they made a bad decision. They would blame the government, the Central Bank, the Deputy Finance Minister and even the retired former Prime Minister. They blame everyone in the world except for themselves! As a result of not admitting that they have made a wrong decision, they never learn from their mistakes and thus will never become better investors.

### ***Loser Mindset No.3 – Rely on 'Sure-Make-Money' Tips***

As told earlier in the story in Myth No.5, even one of the best investors in the world, George Soros, could make a mistake.

Again, this is best represented by the same analogy, if a person who discovers how to turn lead into gold will never give out the secret for USD100 a year.

So now that we know why people lose money, let's discover what sets average and successful investors apart.

## **The Mindset of Successful Investors**

### ***The Right Mindset No.1 – Buy on Logic & System***

Successful investors never allow their decisions to be swayed by their emotions or by the advice of other novices. They buy and sell their investments based on well-defined criteria.

They may not make profit all the time, but the moment they lose money, they would sell without letting their fear, pride or ego get in the way.

For example, Warren Buffet only purchases stock below their intrinsic value and fill his portfolio with such companies. He pays less attention to earnings per share but instead looks for solid returns on equity, high operating margins and low debts. In addition to that, he also looks for companies that generate a lot of cash flow and have consistent operating history for at least over a 10-year period. Before buying a stock, he goes on to analyse the strength of the management team. If a stock does not meet every single criterion, he would not buy!

### ***The Right Mindset No.2 – Be Responsible for Your Mistakes & Results***

Successful investors learn from their mistakes to become smarter investors. Because of that, they would make better decisions in their next investment. George Soros was quoted to have said, "It's not whether you are right or wrong that's important, but how much money you make when you are right and how much money you lose when you are wrong."

As quoted by the legendary investor himself, he knows that he may be wrong from time to time. However, he focuses on minimising his losses by admitting his mistakes early. He takes responsibility for every decision that he makes.

### ***The Right Mindset No.3 – Be Passionate About Becoming an Expert***

Successful investors don't rely on predicting the market's next move. Prediction is the bread & butter of investment newsletters and mutual fund marketing but not for successful investing. Rather than believing in predictions, I would rather believe in making ample preparations. When you are well



prepared, you are going to profit from the market regardless if the market is moving up or down. Oprah Winfrey once said and she said it best, "Luck is when preparation meets opportunity."

Being a successful investor is not about having profitable or 'lucky' picks. Successful investors do their homework and due diligence. They prepare themselves by doing all the necessary research. Opportunity then presents itself with a good price to buy or perhaps some company news was just released, and the price jumps up. When you have made ample preparations, you will be presented with solid opportunities for making successful investments and ultimately profit.

Luck is what you make and build yourself. Luck comes from within, not from external forces. Believe in preparation, not prediction.



## CHAPTER 2 \_\_\_\_\_

### The Idiot-proof Ways to Invest in Funds

#### Having Fun with Funds

At the beginning, funds were positioned as a way for the little guy to get a piece of the pie. For those who do not want to spend time poring themselves over the financial pages of newspapers, getting stressed by financial jargon and studying annual reports of companies, all you needed to do was to buy a fund which will help pave the way to financial riches.

But the catch is this. Investing in funds isn't as easy as ABC. Not all funds are created equal and with innovation from financial institutions such as fund management companies to insurance companies – fund investing has become a science itself.

## So, What Are Funds Created For?

1. Investors who do not have the time nor expertise to manage their own portfolios.
2. Investors who do not have the sufficient initial capital outlay to invest into a portfolio of stock or shares to get appropriate diversification from a portfolio allocation perspective.

These days, investors have several ways to invest in funds. You can buy unit trust, mirror funds or ETFs (Exchange Traded Funds). Do you know commonalities and differences among them?

## What is a Unit Trust?

In layman terms, unit trust is a collection of stocks and/or bonds. The fund management company managing a unit trust brings together a group of people who want to invest their money into stocks, bonds, futures and other securities. Each investor (unit holder) owns shares (units) which represents a portion of their holdings in the unit trust.

Your unit trusts would typically rise in value through income from the dividends on stocks, interest on bonds and capital gains on the securities held in trust. In addition, you sometimes have a choice of whether to receive cash distributions that a unit trust may pay out, or to reinvest the distributions and get more units.

## What is a Mirror Fund?

A mirror fund is typically managed by a life insurance company. Through a mirror fund, an investor is able to access unit trust funds managed by fund management companies through their life insurance policy. For example, if you hold a

life insurance policy issued by Allianz or Prudential, then you are likely to be offered an option to top up an additional fee or charge so that you can invest into an Allianz or Eastspring unit trust fund.

The mirror fund may hold a small amount of cash in addition to the investment in the underlying fund. Therefore, the unit price of the mirror fund differs from the price of the underlying fund. However, the price of the mirror fund, and hence the performance of the mirror fund, will rise and fall broadly in line with the performance of the underlying fund.

## What is an ETF?

An exchange-traded fund (ETF) is an investment fund traded on the stock exchange, much like stocks. ETFs track an index, a commodity or a basket of assets like an index fund. But it differs from an index fund, which has its net asset value calculated daily. Instead, ETFs experience price changes throughout the day as people buy and sell shares through the exchange. In addition, ETFs can be sold short (when investors think the index value they track will fall) and bought using margin (borrowed money). Similar to investing in stocks listed on the exchange, ETF transactions incur brokerage commissions on top of the annual management fee charged by ETFs (though usually the fee is low).

While many among the public are well versed in unit trust or mutual funds, I'm not a big fan of the products myself. These are the three main reasons why I'm against buying unit trust.

First, do take note that you will never know the actual price of the funds that you buy or sell because a mutual fund's **Net Asset Value (NAV)** is only known a few days after buying or selling.

Second, mutual funds are generally sold through Banks, Financial Planners, Financial Advisors and in some countries, through Unit Trust Agents. In Malaysia, there are agents who made millions of dollars by just selling unit trust alone. So, you can imagine how many people are investing into mutual funds or unit trust in Malaysia due to the lack of awareness of ETFs.

Third, when you invest into mutual funds or unit trust, you are paying high sales charges and annual management fees, sometimes as high as 5-8%!

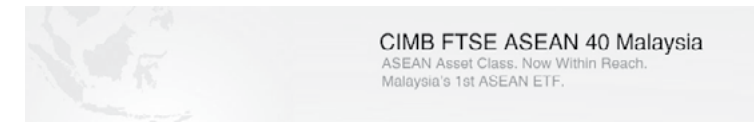
So, where do I put my money then? When looking at a basket of companies, I prefer using ETF. The following are the 3 reasons why I prefer looking at ETFs.

First, ETF prices are updated throughout the day because it acts like a stock. Therefore, you will know the exact price that you are buying and selling it at.

Second, because ETFs are bought and sold like any other stock, there is an ease of transaction when you buy or sell. You can do it through your broker. I prefer using an Online Broker for lower brokerage fees.

Third, besides the normal brokerage fees that is charged when buying or selling, you generally pay between 0.7% - 1% per year for management fees, trustee fees and maintenance fees combined.

At this point in time, there are 5 ETFs in Malaysia:



#### 1. CIMB FTSE ASEAN 40

This fund follows the FTSE/ASEAN 40 index, which consists of the 40 largest companies by full market value listed on the stock exchanges of Indonesia, Malaysia, Philippines, Singapore and Thailand that qualify for inclusion in the FTSE/ASEAN Index.



#### 2. CIMB FTSE Xinhua China 25

This fund follows the FTSE/Xinhua China 25 Index which consists of the 25 largest and most liquid Chinese stocks (Red Chip and H Shares) listed and traded on the Hong Kong Stock Exchange (HKSE).

#### 3. MyETF Dow Jones Islamic Market Malaysia Titan 25

MyETF-DJIM25 is the first Shariah ETF introduced in Asia. The benchmark index for MyETF-DJIM25 is the Dow Jones Islamic Market Malaysia Titans 25 Index. Its status as a national ETF derives from the participation of 7 government-linked investment companies as its initial seeds. They are Khazanah Nasional Berhad, Kumpulan Wang Persaraan (Diperbadankan), Kumpulan Wang Simpanan Pekerja, Lembaga Tabung Angkatan Tentera,

Lembaga Tabung Haji, Permodalan Nasional Berhad and Valuecap Sdn. Bhd.

#### 4. ABF Malaysia Bond Index Fund

The fund is Southeast Asia's first bond exchange traded fund. It is essentially a unit trust, but its units are listed on Bursa Malaysia. The fund is a portfolio of Malaysian government bonds comprising of a basket of Ringgit denominated bonds. The index basket consists of Malaysian government bonds.

#### 5. FTSE Bursa Malaysia KLCI ETF

This fund follows the performance of the FTSE Bursa Malaysia KLCI. When you buy the FTSE Bursa Malaysia KLCI ETF, you are effectively buying into the Malaysian market performance by owning top 30 Malaysian companies.

Nevertheless, the establishment of ETFs in this country is rather immature at this point in time and therefore, lacks liquidity in the market – one of the downsides of ETFs.

Now that you are aware of a new investment instrument known as ETF, let me share with you another type of fund that I also invest into personally.

When I was approaching the age of 21, my parents asked me for my greatest wish for my 21<sup>st</sup> birthday. I did not request for a new car, mobile phone or big fat angpow filled with cash. Instead, I requested for a lot of iCapital stock which was trading at around RM1.26 at that time. The main reason why I was so enthusiastic about iCapital was the fact that it was the only Closed-End Fund that was listed on Bursa Malaysia,

which I would regard as the Berkshire Hathaway of Malaysia. I also had a huge admiration for the owner of iCap, Mr. Tan Teng Boo. A well-known figure for his critical writing and constant criticism of Malaysia's past mismanagements, white elephant projects and poor economic policies, I regard Mr. Tan Teng Boo as one of the best fund managers in the world! Today, iCapital is trading at RM2.42 (January 4th, 2017) and my 'unconventional angpow' has almost doubled in value!

So, what is a closed-end fund all about?

### Closed-End Fund

There are two types of mutual funds – open-end funds and closed-end funds. Imagine that they are twins who share the same DNA but go through life doing things very differently.

Both these funds sell shares to investors and use the money invested to buy securities that match their investment missions. But that's where the similarities end.

When people say 'mutual funds', they are usually referring to open-end funds. Open-end funds can sell an unlimited number of shares to investors. The price per share – also known as the net asset value (NAV) – is calculated by dividing the market value of the fund's assets by the number of shares held by investors.

If a fund has net assets of USD100 million and there are 5 million fund shares in the hands of investors, the fund's share price would be USD20. That's why open-end mutual funds trade only at the end of each day, when trading stops and the final price can be calculated.

Most people own the open-end variety in their retirement and taxable accounts.

Now, let's look at the lesser-known twin, closed-end funds. These funds issue a set number of shares at the fund's origin that trade on the stock exchange throughout the day. The value of these shares is based on demand. If lots of investors buy shares, the price goes up. If investors dump them, the price goes down.

The same is true for closed-end funds. If you invest in a closed-end fund with a share price that is lower than its NAV, congratulations, you're getting a discount. If the gap between the fund's share price and its NAV narrows after you invest, you'll receive a bonus when you sell shares. Just as though the price of that bag of coins went up when you sold it.

But don't get overly concerned with these figures. Most closed-end funds offer a discount. The key is knowing how much of a discount they're offering and whether you think the fund will perform well over time. If it does, and the discount shrinks after you've purchased shares then you earn a profit.

Like open-ended funds, closed-end funds come in dozens of types ranging from US stock and bond funds to funds that invest in a single country or region. But don't confuse a closed-end fund with a 'closed fund'. A closed fund is an open-end fund that no longer accepts new investors.

Closed-end funds tend to be actively managed – meaning the fund manager buys and sells securities in an effort to outperform the fund's benchmark index, such as the Dow Jones Industrial Average (DJIA) or Kuala Lumpur Composite Index (KLCI). Watch out: this buying and selling could result in higher fees and increased taxes, if you hold the fund in a taxable account.

## Should You Invest in a Closed-end Fund?

In recent years, closed-end funds have fallen out of favour with average investors. That's largely due to the rise in popularity of exchange-traded funds (ETF).

Closed-end funds do have a few benefits:

- A closed-end fund's discount offers you a bonus when the gap between the share price and NAV narrows after investment.
- A closed-end fund's manager can invest without worrying that cash may be needed to meet sudden redemptions by large number of jittery investors as is the case with open-end fund managers.
- Closed-end funds tend to pay investors higher levels of income because they invest more heavily in income-producing assets – more inflows of new money.

Bottom line: Unless you're willing to roll up your sleeves and research closed-end funds and their discounts, you're probably better off in ETFs.



## CHAPTER 3

### The Idiot-proof Ways to Invest in Stocks

When I first began my education in investment, the first question that popped into my mind was “Who is the best investor in the world?”

There was no doubt; at the top of my mind, the best investor is none other than Warren Buffett, who made his fortune from nothing to USD60 billion, doing nothing else but investing in stocks. If you had invested USD10,000 in Berkshire Hathaway when he took control in 1965, your holdings would be worth more than USD50 million today.

#### The Story of Warren Buffett

Warren Buffett was born during the era of the Great Depression when his father was close to bankruptcy.

Since young, the “Oracle of Omaha” had displayed great interest in making and saving money.

When he was in elementary school, he would tell his classmates that he wanted to be a millionaire before the age of 35. He found a book titled ‘A Thousand Ways to Make \$1,000’. By the age of 6, young Buffett was already making money. He would buy Coke bottles at 25-cents per six pack and sold them at 5-cents per bottle, giving him a 16% gross profit. At the age of 13, he started a job delivery business. He would get deals from house to house and hire the kids around his neighbourhood to do the delivery for him. He was serving 500 customers a day. At the age of 11, he took all his savings and started investing in the stock market. His first investment was three shares in a company called ‘City Service’. His interest increased and he started spending his time reading company annual reports.

By the age of 14, young Buffett was making as much as the average 25 year old in 1944. He was even making passive income from his pinball machines that he installed in pubs and restaurants all over town.

Warren Buffett has made a name as the most successful investor of the 20th century. A student and friend of Benjamin Graham (the father of Value Investing), Buffett has managed to amass one of the largest fortunes in history through his company, Berkshire Hathaway.

Despite his tremendous wealth, the fourth richest man (listed in Forbes The World’s Billionaire listing as of 2013) in the world still lives in the same house he bought 30 years ago, for \$31,500, drives an older Lincoln Town car and downs countless cans of Coca-Cola every day.

## What is Warren Buffett's Strategy to Make Billions Through the Stock Market?

The strategy employed by the world's greatest investor and among the richest men in the world is known as 'Value Investing'.

If you want to be able to consistently beat the market and make higher returns than anyone else, let's start by adopting the beliefs and mindsets of a Value Investor.

### **Lesson 1: Understand the Business Behind the Stock**

Most people, in my opinion, buy stocks like buying Toto or 4D. They buy based on rumours and sell based on facts. They buy based on world events that influences the movement of stocks. Many of these gamblers or speculators know very little about the business model, business operations and business plans behind the stocks they own.

Warren Buffett was different. When he buys a stock, he sees himself as a shareholder or owner of the business. He knows that the only way he can make consistent returns on his money is to identify good businesses that are run by a strong management team. Good businesses will generate higher profits. Higher profits will increase the value of the company. The increment in the value of the company will thus increase the share price.

When you understand the business behind the stock, you will start to see stock market investment differently. Ask yourself when making a decision before buying a stock, "Will you invest into this business if it is offered to you privately?"

### **Lesson 2: Understand the Concept of Mr. Market**

While most textbooks, lecturers and financial experts

will teach you the concept that the market is rational and efficient, Benjamin Graham taught Warren Buffett otherwise. Graham suggests that the stock market prices are determined by demand and supply, which in turn are irrationally driven by fear and greed. At times of optimism and greed, investors rush in to push a stock's price way above its value. At times of fear and panic, investors sell their shares, causing the stock's price to fall way below its value. In other words, a stock's price does not always reflect the true value of a company.

### **Lesson 3: Learn to Be Greedy When Others Are Fearful and Be Fearful When Others Are Greedy**

Most people get their source of stock selection from mainstream media like the newspaper, online media, radio or TV. They tend to buy stocks upon hearing a lot of good news about it that pushes the stock price higher. The danger of that is that most of them don't realise that the mainstream media is always after yesterday's news. By the time the public knows about it, the average investor who lacks skill would jump in. However, jumping in at this time would already be too late, as stock prices would have already risen near its peak! It is just a matter of time when the stock prices start falling and out of fear, the average investor will sell the stock and end up with a loss.

On the other hand, value investors take a contrarian approach. They go against the market psychology and trend. They buy when nobody wants it because that's when the stock price is extremely low and attractive. They then wait patiently for the stock to come in favour again. When the public starts buying, the average investor will once again push the price higher and higher. That's when value investors will sell their shares at a nice profit.

### **Lesson 4: Learn to Do Nothing When There is Nothing to Do**

The problem with professional fund managers of unit trust is that they are pressured to invest most of their money in the market even when there's nothing to buy. In fact, most people think that if you are a professional investor, you have to be investing every single day. That's totally wrong!

A value investor is more than happy to keep his money in cash and only invest when he has a high chance of winning. They are not pressured to invest their money.

Warren Buffett learned from Benjamin Graham on how to develop a systematic way to determine a stock's true value (known as its 'intrinsic value'). Graham taught Buffett how to buy stocks when its undervalued and make a huge profit when the price is eventually overvalued.

Another teacher of Buffett was Philip Fisher (the father of Growth Investing). Fisher taught Buffett how to develop a way to not only find undervalued companies but to find companies that have the potential to significantly grow in their earnings and thus increasing the chances of growing into a company of higher stock value as time goes on.

So, how powerful can this strategy be?

#### **The 3 Main Keys of a Value Investor**

Now that you have learnt how value investors like Warren Buffett grew his funds from thousands to millions to billions, let's look at the specific strategies they have used to create tremendous wealth in the stock market.

### **What is the Business Model?**

Remember that when you are buying a stock, you must see yourself as a shareholder of the business. In fact, the best way is to ask yourself, if this business was offered to you privately, would you take it? If you want the value of your stock to increase over time, I'm sure you will seek to understand the business behind the stock before committing your hard-earned money into it.

So, what's the definition of a good business?

A good business is one that you can predict with confidence that this company would generate long-term profit and hence the stock value will increase. When the value of the company increases, so will the stock prices.

However, you must understand that although a company may be able to generate profit, there is no guarantee that it can continue to do so in the future. Like it or not, new competitors can enter the market to steal some market share causing the company to experience lower sales and earnings. So, how can we prevent this from happening?

The answer is a Unique Competitive Advantage (UCA). So, where does a company's unique competitive advantage come from?

#### **Case Study 1 – A Strong Brand**

What allows McDonald's to expand every year, opening new stores and allowing it to consistently increase its earnings? Why can't McDonald's competitors capture all its customers by offering cheaper prices and better quality? Even though there are so many new fast food chains in the market, why aren't they able to take away all of McDonald's customers?



The answer is because the McDonald's brand name gives it a unique competitive advantage.

People from young to old visit a McDonald's every single day because of the loyalty towards the brand and the powerful feeling associated with McDonald's stores and food. There are many other burgers other than McDonald's like Burger King or even our own homegrown Ramly Burger, but McDonald's has built its business with a sustainable competitive advantage. This is also the reason why during the US subprime financial crisis in 2007 to 2009, McDonald's business was hardly scathed while most other stock prices took a plunge.

### **Case Study 2 – The Monopoly in the Industry**

A powerful brand name is not the only thing that gives a company a sustainable unique competitive advantage. If a company monopolizes the market, this creates an even bigger competitive advantage. For example, Bursa Malaysia is the only stock exchange in Malaysia. For any company that wants to list their company in the stock exchange, the only place they can turn to is Bursa Malaysia. It would be almost impossible for anyone to start a new stock exchange in the country to take away Bursa Malaysia's chunk of business.

### **Case Study 3 – Gigantic Economies of Scale**

Being a large company with huge economies of scale provides the company with a unique competitive advantage. For example, as healthcare becomes more important, investors around the world starts looking at Malaysia's medical gloves industry. Why is that so? It's simply because Malaysia is the top producer of medical gloves globally. For rubber gloves, one should concentrate on 2 companies; Top Glove is the largest natural rubber gloves maker globally while Hartalega

is the largest producer of nitrile gloves. As far as I know, there are no substitutes for latex gloves and nitrile gloves. Besides the prices of latex and raw materials for nitrile gloves, all the players are on a level playing field except for quality and economies of scale. Therefore, due to both companies being of massive size, they have better competitive edges with their capacity that enables them to invest in better R&D activities, acquire rubber plantation lands to increase their production capacity and thus enjoy better margins in terms of revenues and profits.

### **Case Study 4 – Market Leader**

What makes a market leader?

A market leader is defined as a brand, product or company that has the largest percentage of market share that often dominates over its competitors in the aspects of customer loyalty, distribution coverage, brand image, perceived value, price, profit and promotional spending. So, what is a good example of such a company? Why don't you try to Google it?

Google's index of web pages is the largest in the world, comprising more than 3 billion webpages. If they were all printed out, it would result in a stack of paper 130 miles high! The Google search engine receives more than 200 million search queries globally in a day. More than half of which comes from outside the United States of America. Over 70% of all searches conducted on the Internet originates from Google! This figure is increasing all the time! In fact, think about it, Google has become an indispensable part of our online lives and it would be very challenging for any other competitor to take away a huge chunk of Google's online business.

## Case Study 5 – Trade Secrets

A company's unique competitive advantage can also come in the form of a special formula they own. One of such companies is Kentucky Fried Chicken (KFC). In year 2008, KFC removed Colonel Sanders' original handwritten recipe of 11 herbs and spices that have been the company's signature fried chicken from its safe storage place. The 68-year-old recipe, that had been resting inside a locked filing cabinet inside a vault at the company's Kentucky headquarters, was carefully removed under the watchful eyes of many guards so that the company could upgrade the security around the piece of paper. What was all the fuss over one simple piece of paper and why would KFC need to keep the recipe under such tight security?

That's simply because KFC's recipe is part of a larger class of corporate knowledge that allows the company to gain a competitive advantage over the rest in its industry. In this case, KFC feels that its spice blend enables the company to make particularly delicious chicken that's differentiated from the rest of the fried chicken in the market. The public seems to agree and this is probably why as of the year 2012, there are over 18,000 KFC outlets in 12 countries and territories around the world!

### The Importance of Sustainability

#### Step 1 – What is the Long-Term Outlook of the Company?

While it is important to look out for companies with unique competitive advantages, it is also very important to look for sustainability and the long-term outlook of the company.

For example, during the initial entry of mobile phones into the consumer market, Motorola stood out as one of the market

leaders globally. But it wasn't long before Finnish company Nokia, took over the lead by having one of the largest market share in the world. At one point in time, everyone was going crazy over Nokia mobile phones.

Nokia enjoyed a considerably long period of time having the largest market share compared to its competitors until it failed to cope with the drastic changes brought by the emergence of smartphones. Blackberry entered the market thereafter and ate up a huge market share in the mobile phones industry. Blackberry created an upscale, smartphone industry and everybody frenzied over its QWERTY keyboard. As timely as it gets, the Apple iPhone made an entry into the mobile phone industry and was quick to win consumers around the world starting with the sophisticated technology-loving early adopters. Apple stores never fail to attract fans swarming into their premises every time a new iPhone is launched. The iPhone phenomenon has effectively raised the par for smartphones, giving an even greater challenge than before, to the rest of the mobile companies. Almost every company began adopting the iPhone's design philosophy as the mobile phone's new standard. Today, Apple no longer dominates the mobile market as Samsung introduced its Galaxy and Note series to the market and again, turning the mobile industry upside down in more ways than one.

Motorola, Nokia, Blackberry, Apple and Samsung all had its fair share of market dominance in terms of brand and market share at one point of time. Unfortunately, the fast revolutionizing nature of the mobile industry presents a highly unsustainable competitive ground for the companies. Hence, if you want to look for an idiot-proof way of investing into stocks, it is good to look for industries that are boring but sustainable. The Fast-moving Consumer Goods (FMCG), pharmaceuticals, healthcare, education F&B, alcoholic beverages (not that I'm encouraging you to drink more

alcohol), water and electrical utilities are some examples of the more viable choices in this case.

If the company that you plan to invest into has no plans to create new products or enter a new market, the future growth of this business will also be limited. Hence, it is also important to ensure that the company you want to invest into constantly seeks to stay ahead of the competition, or at least, has plans to develop new products or expand into new markets or territories.

### **Step 2 – Who is Running the Business?**

I like to picture business like taking part in an F1 competition. One that needs racing tracks, racing cars and drivers. It's pretty much the same when it comes to businesses. The racing track represents the industry where all the companies compete in, while the racing car represents none other than a competing company itself. Now, what good is the best car if a lousy driver is behind the wheels? The driver of the car thus represents the management of the company.

It is normal for people to conduct credit checks on organisation's business models and their operations. What they don't look at is the people behind these organisations. Imagine if you were to be a shareholder of a business, don't you think that it is important for you to know who are your business partners and the people running the business? A good management is like the driver that ensures the safety of the car while he races on to win the race.

When you start understanding the people behind a business, it gives you an added advantage to decide if this management team is honest and capable of driving the company's strategy that in turn will drive the company's profitability. It's like knowing that you are going to buy a

good car and knowing who is driving it so that you have a higher chance of winning the race.

## **How Do We Objectively Evaluate Management Performance?**

### ***Evaluation 1- Management's Stake in the Company***

If you find that the key senior directors like the CEO, CFO or COO are collectively selling a large portion of their own stock, do you think that they have faith in their own company's future? If even the company's own directors do not have faith in their own stock, how would you have faith then?

A good management has substantial ownership in the company. They believe that there is no better alternative for their own money than placing it in the company. If you find that the senior management is collectively buying a large amount of the company stock, it can be a good indication that the people who are in it is getting a good deal at the current price. Anyway, who else would know of the company's future better than the ones running it every single day?

### ***Evaluation 2 – The Honesty of the Management***

I always equate most CEOs to the best salesman of the company. Like it or not, they are the ones who have to ensure the confidence of the shareholders and employees and they would often paint a rosy picture of the future of his/her organisation.

When looking at the top management, it is important to look for a team with clear mission statements, management plans & goals. In fact, it is good to find a CEO who is not afraid to admit that they have made mistakes. Even Warren Buffett would ask for apologies for mistakes of commission

and omission. At times when he invested in a company that performed poorly, he would be quick to admit it. He also guarantees that there will be more of such mistakes in the future.

A way to evaluate the management is to read the company's annual reports to analyse if the management has implemented plans that they have discussed before. What you want is a management who is not afraid to admit his/her mistakes and is consistent with his/her words and actions. A strong management is usually one who is consistent in their plans and delivery of results. Watching a company's press releases is the best way to understand this and to apply it practically.

### **Evaluation 3 – Mission First. Team Second. Individual Third.**

You should also look for management who thinks and invests like a business owner. In other words, someone who would invest in projects and activities that creates value for their shareholders in the long run. A good example of otherwise would be CEOs of top-tiered banks who continue to receive fat bonuses despite lousy performance as seen in the recent financial crisis.

However, you must also take note that top managements of different industries are paid different rates in accordance to their respective industries. You can get a good comparison of the management's pay-out rates by looking at their peers within the same industry. If the management is making huge sums of money while the company is in bad shape, you must understand by now that this is an unhealthy practice. If management really cares about its investors, this wouldn't be the case.

### **Step 3 – Understand the Story of Numbers**

Now that you have identified what makes a good racing car (company) and a good driver (management), it's time to identify how much you are going to buy this business for.

When you buy a stock, it doesn't mean that you buy once you spot a good business with good management. Just like buying clothes, the best time to make your purchase would be during a 'great clearance sale!' That's when you buy good valued companies at discounted prices! You buy a good company's stock when it is selling below its intrinsic value.

So, what's intrinsic value all about? It's the actual value of the stock based on its profit-making ability.

To know if a stock is undervalued, overvalued or trading at fair market value, we need to rely on financial ratios.

For the financial ratios, you can either get them from our daily newspapers or websites like [www.bursamalaysia.com](http://www.bursamalaysia.com) to download the annual reports of public listed companies. Inside the annual reports, there are numerous statements such as balance sheets, income statements, statement of changes in equity, cash flow statements and notes to the financial statements. It is also important to note that when you are valuing a company using financial ratios, you must compare a few other companies within the same industry for a better valuation of the stocks. This comparison in investor terms is called peer comparison.

### **Ratio 1 – Earnings Per Share (EPS)**

Basic EPS measures the returns to the shareholder for every share invested. It is derived from dividing the company's earnings attributable to ordinary shareholders by the number of shares.

$$\text{EPS} = \frac{\text{Net Profits} - \text{Preference Dividends (if any)}}{\text{No. of ordinary shares}}$$

So, would you want your returns high? Of course, you do! Therefore, the higher the EPS, the better!

### **Ratio 2 – Price Earnings Ratio (PE Ratio)**

PE ratios are easily available in our daily newspaper. It is calculated by dividing the price of shares by earnings per share (EPS).

$$\text{PE Ratio} = \frac{\text{Share Price}}{\text{EPS}}$$

For example, if stock A's earnings per share is \$1 and stock A is selling at \$10, its PE ratio would be 10 (10 divided by 1). In this example, it means that for every \$1 stock A is earning per year, investors are willing to pay \$10 for that share of stock A. On the other hand, if stock B is priced at \$20 a share and its EPS over the year was \$4, then its PE ratio would be 5 (20 divided by 4). Therefore, it would take less time to recoup your capital if you were to buy stock B over stock A.

So, would you love the PE ratio to be high or low? Of course, the lower the PE ratio, the more attractive the stock is, as it means a shorter time period to recoup your investment. Another good thing about low PE stocks is when the stock market crashes, these low PE stocks are more resilient.

In addition to this it is also important to perform peer comparison, as mentioned earlier, to see if the stock is overpriced. A high PE ratio doesn't mean the stock is expensive because the stock may have a high growth prospect in its future earnings. So, investors snap up the shares in anticipation of the future.

### **Ratio 3 – Returns on Equity (ROE)**

The ROE reveals the rate at which shareholders are earning income on their shares.

When you invest your hard-earned money in a company, you want the management to take good care of your money. The ROE, commonly referred to as 'stockholder's return on investment' measures the company's ability to make use of its assets to generate profits. A high and consistent ROE indicates that this company has a strong management who uses its resources effectively.

ROE is calculated by dividing the company's net income (after tax earnings) by its total shareholder's funds. Total shareholder's funds include paid-up share capital, revenue reserves (retained profits) and capital reserves.

$$\text{ROE} = \frac{\text{Net Profits} - \text{Preference Dividends (if any)}}{\text{Total Shareholder's Funds}} \times 100\%$$

When comparing ROE within the same industry, it's a good indication to know which company has a sustainable advantage among its peers in the industry.

Generally, a company that yields a consistent 15% ROE is considered a good investment.

### **Ratio 4 – Debt Equity Ratio (DE Ratio)**

The debt equity ratio is calculated by dividing a company's total debt by its shareholder's funds.

$$\text{DE Ratio} = \frac{\text{Short Term Liability} + \text{Long Term Liability}}{\text{Total Shareholder's Funds}} \times 100\%$$

If stock A has debt equity ratio of 0.5, it means that this company has \$0.50 in debt for every \$1 in assets. However, if

stock B has debt equity ratio of 1, it means that for every \$1 in assets, stock B also has \$1 in debt. So, which company is financially stronger?

In the example above, stock A is financially stronger because it has less debt compared to stock B. While taking on some debt is a good strategy to raise cash for expansion, taking on too much debt can lead to a challenge to the company when the interest rates are high as the company will experience a cash crunch which would erode its earnings.

### Ratio 5 – Net Tangible Assets (NTA)

If you want to know the net worth of a company, refer to its NTA.

NTA measures the value of the shares in terms of the company's assets. It is the value of assets attributable to shareholders expressed as per-share basis.

$$\text{NTA} = \frac{\text{Paid Up Capital} + \text{Reserves} - \text{Preference Share Capital} - \text{Intangible Assets}}{\text{No. of Ordinary Shares}}$$

The higher the value of the NTA, the greater the financial foundation of the company.

In general, investors are recommended not to pay for a share price that is more than its NTA. However, stocks from service and finance industries usually can command higher share prices in regards to their NTA.

### Ratio 6 – Dividend Yield (DY)

Dividend yield measures the actual cash returns you receive from a company. This is a concern for investors as they are profits in addition to the gains from the price of shares rising.

Dividend yield is computed by dividing the dividend paid per share by the market price per share, at a specific date.

$$\text{DY} = \frac{\text{Dividend per Share} \times 100\%}{\text{Market Price}}$$

Dividend yield is useful for comparing profitability with other investments. For example, if you put \$1.00 in the bank, you gain a return of \$0.03 if the interest rate is at 3%. However, if the dividend yield of stock A is 4%, it means for every \$1.00 you invest into stock A, you gain a return of \$0.04. So, it makes more sense to invest into stock A rather than putting your money into the bank.

In summary,

**Earnings Per Share (EPS)** tells you how much a company earns.

**Price Earnings Ratio (PE Ratio)** tells you how fast you can recoup your capital.

**Return on Equity (ROE)** tells you how efficient a company is.

**Debt Equity Ratio (DE Ratio)** tells you how much debt a company has.

**Net Tangible Assets (NTA)** tells you the net worth of the company.

**Dividend Yield (DY)** tells you the annual returns in cash.

You have looked at how value investors find low-priced value by looking at some of the ratios above when they evaluate the relationship between a stock's level of excellence and its price.

However, it is also important to remember that these are not the only things that value investors analyse, but rather a brief snapshot to tell you the story of the company behind the numbers.