CREATE A SECONDARY INCOME STREAM

THROUGH LONG TERM SHARE INVESTING

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Chua I-Min, CFA

Let's

Create a Secondary Income Stream

together...

Through Long Term Share Investing!

Chua I-Min, CFA

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A Word from the Author - Chua I-Min, CFA

This book marks a significant milestone in my life. I was brought up in a conservative family: My Dad is a primary school teacher and my Mum is a nurse, both held the same job for more than 30 years! The concept of stability and prudence is deeply ingrained in both my siblings and me throughout our growing up years. Coming from such a background, to be an entrepreneur is indeed a big step. Even though I know that I am not cut out to be a corporate rat, it took me 10 years to step out of a stable job and a monthly pay cheque!

I am glad I have done it and I don't have a single moment of regret. Today, I am happy to declare that I work for myself and I only do work that I am passionate about. This book is a testimony to my current status: It would not have been written if I am still cooped up in a corporate office!

The content I delivered in this book is also one of the main contributors for giving me the courage to pursue what I really want to do. After practicing more than a decade of shares investment, I can personally testify its capability in generating a Secondary Income Stream, and with this income engine, the decision to take the leap is a lot easier!

Of course this would not be possible without the support from my family. My wife did not even question my plan when I told her that she is not going to have a stable family allowance. I needed to convince my mum a little but soon got her support. Thank you so much!

Looking at this book in printed form brings me a lot of joy. I must thank AB Maximus and SGX Academy, specifically, Beng Hooi for giving me various pointers, and Wei Luo and Young for helping me to make this book marketable.

Words of thanks must also be given to my course participants, who supported my course and the book. Your words of encouragement have made all the sweat worthwhile! Really appreciate it!

And lastly, thanks to all who have helped in editing and designing this book to make it presentable. Special thanks to my editor, who also happens to be my course participant, Ruth Chua. This book definitely sparkles more after your polishing.

To you who are reading this book, I hope it will be an enjoyable read. I also sincerely wish that this eventually leads you to a Secondary Income Stream and enables you to achieve your dream life! Thank you so much!

Foreword

To achieve real financial independence, it is important to make yourself less dependent on a specific income stream (i.e. your primary job). Everybody would agree that a secondary income stream would be great, yet few actually do it. Most people either lack motivation or become distracted with other things in life to put effort and discipline to make it happen for them.

Investing is one common means of developing a secondary income stream but the lack of a viable investment plan is a common reason for most failures. Warren Buffet taught us that: 'What is needed is a sound intellectual framework for making decisions and the ability to keep emotions from eroding that framework'.

This book attempts to provide amateur investors an easy-to-read guide on knowing your objectives, risk appetite to develop an investment plan, the macro considerations and the use of some basic financial tools to help in stock selection. You may wish to test your investment plan on paper and then in the market with real money to boost your confidence and understanding of the knowledge learnt. Happy reading & investing to all!

Tolmas Wong, CFA - A financial practitioner & educator

CHAPTER 1: INTRODUCTION

Imagine yourself learning to play a new game. What are the factors that would help you win the game? Very often, we will firstly equip ourselves with the knowledge or skills to play the game. Subsequently, we will try to understand the rules of the game so that we know how to win it. After which, we will derive a strategy to help us achieve our goal. With enough practice, it is highly likely that we will achieve good results and win the game!

Let us take learning how to play basketball for example. Before we enter a match, we need to learn skills like dribbling, passing and shooting the ball. Subsequently, we need to understand the rules of a basketball game. To be able to win a match, we also need to have a good strategy to tackle our opponent. Eventually, whether we win or not depends on how much we practice!

Just like basketball, share investing is just another game. To win, it is necessary to follow the steps mentioned above. Share investing is a "zero sum game" whereby not everyone can be a winner, and there are times when winners profit from the losers. As such, we should be even more prepared, to ensure that we emerge the winners in this game!

There are a few disciplines in share investing to help us win the game. "Fundamental Analysis" is one of the main disciplines widely used in the share investing game. Players adopting this discipline focus on quality of the shares, health of companies and market conditions for making investment decisions. The concepts used in this book subscribes to this discipline. If you are thinking of playing the share investing game with fundamental analysis, this is definitely the book for you!

What do we mean by "Long Term Share Investing?"

Simply put, this is a buy-and-hold strategy whereby for every share we purchase, we have the ability and the intention to hold it for at least three to five years. This is the attitude that I strongly urge all investors to have as it is in line with the principles of investing in businesses: Think about this, if your friend approaches you to start a restaurant and you decide to invest in his venture, when do you expect to get back your investment plus returns?

You probably need at least three to five years to see any money back and that is if you are lucky! As such, is it right to expect quick returns from share investing given that buying a share from the share market is effectively investing in a business venture?

Long term share investing is about investing in a business. There is no difference between investing in your friend's restaurant and buying a share. Of course, the scale of the business varies: Instead of a larger stake in a small restaurant business, you are investing a smaller stake in a large listed company. Nevertheless, you should treat every share purchase with the same rigor as though you are investing in a business venture. By doing so, the chances of you getting back your returns will be much higher!

As a long-term share investor, you will focus on businesses that are profitable over long term. It will be natural for you to understand more about the businesses and the companies. You will also realize that even though market or share prices move up and down, the prices will eventually reflect the true value of the company given time. As such, if you have invested in the right business or company, you will eventually profit from it.

Framework of the Investment Process

Before we dive into details of each individual section, I would like to paint an overview of how each individual part come together to help you achieve your final goal of creating a share portfolio that generates a secondary income stream.

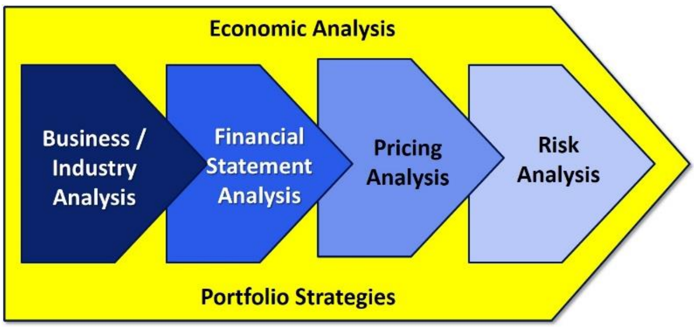


Figure 1.1: Framework of the Investment Process

The Investment Process consist of 2 main parts: Company Selection Process and Portfolio Management.

The Company Selection Process comprising of Business, Financial Statement, Pricing and Risk Analysis act as a filter to sift out companies. The output of this process is a watch list of companies that are fundamentally sound. Please note that the 4 analyses are arrange in order of importance. We have to make sure that the company is good from business and financial statement analysis before we consider whether the price is right with pricing analysis. A common mistake by many investors is that they just invest because the shares are cheap from pricing analysis and without consideration of how good the company is. This is of course dangerous as if the company is bad, cheap shares can become cheaper! In short, there may be situation for us to invest in companies that pass the business and financial statement analysis but fail the pricing test. But we should definitely avoid buying shares that only pass the pricing analysis and nothing else!

Business analysis is the key factor to long-term share investing for obvious reasons. As mentioned earlier, long-term investing is about investing in businesses. Naturally, business analysis would then be the most critical part of the whole investment process! Business analysis enables us to understand businesses better and eventually help us to identify investment themes, or in other words, select companies that are likely to be profitable over long term.

Financial statement analysis enables us to assess the financial health of a company. Just like health reports from our medical checkups, financial statements provide a detailed description of how healthy a company is. This analysis let us know if a company is worthy of our investment and help us sift out those companies in poor health!

Pricing analysis answers the question to whether the share is cheap or expensive. There are various tools to help us to do so. It is important to know how to use these tools and hence have an opinion of the share price before making the investment decision!

Risk analysis is more of a mindset towards investing rather than separate steps that have to be carried out. In fact, while we are doing the rest of the analyses, we are already trying to reduce the risks of investing in a wrong company. This is the reason why we don’t have a separate chapter on analyzing risks.

Nevertheless, it is important to have risk analysis in the framework to emphasize on the risk management mindset. Investing is risky, there is no way we can eliminate risks, but we can reduce risks, we can choose risks. Investors need to understand that after whatever analyses are carried out, nothing is full proof. At the end of the day, a decision still have to be made on whether this risk is worth undertaking or not.

The second part of the investment process is Portfolio Management, comprising Economic Analysis and Portfolio Strategies. With the watch list created from the Company Selection Process, this part gives guidance on when and how to buy and sell.

Economic analysis provides the answers to how and when we should invest at a given point in time. Should we be investing aggressively or cautiously? Should we even be investing at all? Or should we be selling right now? At the same time, it points us to the types of shares we should look at, i.e. Value, Growth or REITs and which industry we should focus on.

Portfolio Strategies looks at your investment objective and risk appetite, two most important consideration in structuring your share portfolio. Through this exercise, you will know how much of your investments should go into higher risk shares (growth shares) and how much into lower risk shares (income shares and REITs).

Putting the various steps together, we will first go through the Company Selection Process - Business, Financial Statement, Pricing and Risk Analysis to create a watch list of shares that are fundamentally sound. Or basically answer the question, what to buy. This is followed by Portfolio Management – Economic Analysis and Portfolio Strategies to answer the question on when and how to buy. What, When and How – these are all you need to find out for this investment game!

Structure of the Book

As mentioned earlier, this book consists of three sections following the steps you would adopt in winning games. This is how you can look at it with the basketball game example: In the basketball game, you must first learn the basic skills of dribbling, passing and shooting the ball. Back to our share investing game, the basic skills you need to learn are Business Analysis, Financial Statement Analysis, Pricing Analysis and Economic Analysis. **Section 1** covers these basic skills. (There is no separate chapter for Risk Analysis as managing risks is part and parcel of the other analyses).

After you know how to dribble, pass and shoot the ball, you need to know the rules of the basketball game and be familiar with the basketball court. I will do the equivalent for our share investing game in **Section 2**. This section will expand on the most critical rules to win the share investing game, which is to search for either undervalued shares (income shares) or shares of companies with growth potential (growth shares). See Figure 1.2:

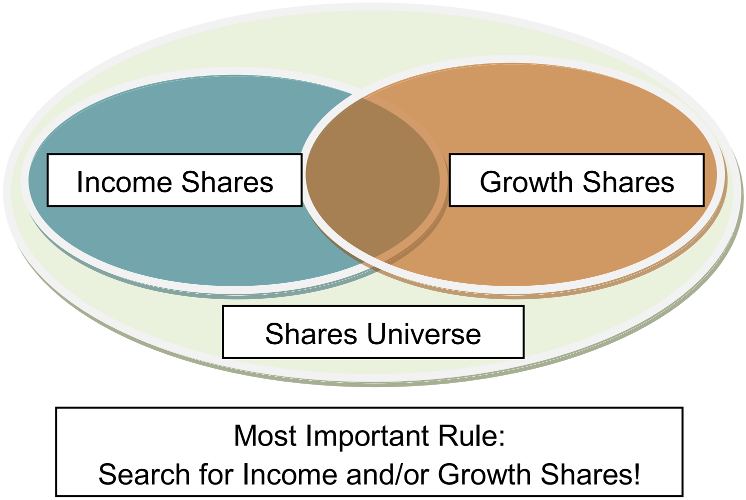


Figure 1.2: Only Invest in Income and/or Growth Shares!

Just as you need to be familiar with the basketball court, you need to know the various components of the share market. This section will highlight the various features about the share market that you should take note of. At the same time, I will introduce some other instruments, namely Real Estate Investment Trusts (REITs) and Exchange Traded Funds (ETFs) that are available in the share market. These instruments can be very helpful in enhancing your shares portfolio.

To win a basketball game, strategizing your game plan is vital. In **Section 3**, we will discuss the Portfolio Strategies as per the above framework. We have exercises to help you understand yourself, your investment objective and your risk profile. After these exercises, you would have all the ingredients spelt out in the investment process!

This book will conclude with a description of the portfolio maintenance activities you need to carry out. With that, you would have all the knowledge required to - **Create a Secondary Income Stream through Long Term Share Investing!**

Are you ready for the share investing game? Flip over to start your learning journey now!

Section 1: Basic Skills

Right Company, Right Price, Right Timing!

CHAPTER 2: BUSINESS ANALYSIS

Business analysis is the most important chapter of the whole book! As I highlighted in Chapter 1, business analysis is the key ingredient to long-term share investing. Long-term investing is about investing in businesses hence analyzing businesses should be the most critical step in the whole investment process!

Business analysis is more art than science. There are no fixed formulae in determining whether a business is good or bad. In this chapter, I will provide you with some guidelines in analyzing businesses to help you appreciate businesses better.

Understanding Business Models

I have some simple rules about understanding business and business models:

Rule #1: Understand how the company's product generates revenue

It is important to know how a company makes money or its revenue generation process. Think of how your company makes money. In my case, I am in the education business and I deliver training programs to generate revenue. The good thing about this business is that my product is unique and does not face direct competition. Let me illustrate further: there are some competing courses similar to mine but some of my course contents would not be available in other courses. Hence, to get 100% of what I deliver, it is not possible to get it from anywhere else.

This is in contrast to a product like shampoo or toothpaste. Whether you use the product from company A or company B, the difference may not be obvious. With the unique nature of my product, I will be able to charge a higher margin. I can thus price my product based on market affordability rather than cost plus method used by most competitive products.

The bad part about my business is that revenue is non-recurring from existing customers. In other words, I always have to find new customers for my training program and after the program is completed, I am unlikely to generate revenue from these same customers. This is unlike products that require refills or continuous servicing. For example, a printer: once you purchase a printer, the company will be able to generate revenue from you continuously as you need to refill the printer's ink.

The revenue pattern of my business is irregular. I only make money when I conduct courses. Many businesses working on project basis have such revenue pattern. For example, ship building, developers, oil rig building, etc. In contrast, there are some businesses with regular income stream. For example, transport operators, REITs, telecommunication companies, etc.

Rule #2 - Understand cost structure of the business

Knowing the cost structure enables you to assess how much the business can grow and how risky the trade is.

Again using my education business as an example, my cost is mainly fixed (venue, marketing cost) with low variable cost (printing of handouts). With such a structure, my profit margin can be very high after my fixed cost is covered. You can look at it this way: the cost to conduct the same program for 20 people and 200 people is only marginally different, as I only need a bigger room and more handouts. It is easy for a business with such cost structure to grow as there is almost no hassle for me to add another customer. Unlike for example a restaurant business: to cater to more customers, they will need to prepare more food, more space, more waiters, more chefs, etc. Such businesses definitely have more considerations when they plan to grow.

Another main consideration for cost is whether the company incurs cost before or after confirmation of revenue. A good example to illustrate is to compare a real estate developer with a construction company. When a developer incurs cost to purchase a piece of land, there is no certainty of its revenue. As compared to a construction company, it usually incurs most of its costs after getting the job from the developers. In that sense, the financial risk for the developers is greater since they need to incur costs without certainty of revenues. Nevertheless, this is also the reason why they are able to achieve extraordinary profits some of the time.

For Rule #1 and #2, we seldom have a business that is significantly more superior than the other. Every business will have their pros and cons in terms of revenue and cost structure. So in choosing the company to invest, using these 2 rules, is not about finding which business is better but which business have pros outweigh their cons in your opinion.

Rule #3: Identify key criteria to survive in the business and if the company has it

In every business, there must be something done right in order for it to survive. For example, the key to survive in a food business is delicious food and the key to survive in my education business is up-to-date content. This is one good way to assess if company can survive for the long term. If a restaurant cannot serve good food and a construction company builds houses that leak, please eliminate them from your investment watch list!

Rule #4: Identify competitive advantage of the company

Competitive advantage analysis is a more stringent test as compared to rule #3. In the business environment, doing the necessary may not be good enough. For business to thrive, they need to be better than their competitors. A good example is the various burger joints available. Most fast food restaurants make decent burgers but it seems that some are doing better than the rest. One possible reason could be that the better ones having competitive advantage from their restaurant management system, which manages the restaurant in a way that the customers' experience in terms of ambience, waiting time, sense of value, etc is better.

When analyzing business, always try to identify what are the things that the business is doing to maintain its competitive position and verify if it is sustainable. If the answer is yes, it is worth considering investing in such companies!

Rule #5: Identify growth opportunities of the company

One of the most important rules of long term investing is investing in companies that are likely to be sustainable and more profitable in the next five to ten years. Hence, the question you may want to ask in analyzing business is what are the growth opportunities for the company?

Back to my education business example, why I want to switch into this business is because I see many areas of growth. Firstly, adult learning is gaining popularity and more people are willing to upgrade themselves continuously. Secondly, this is a scalable business as highlighted in rule #1. My cost to conduct training for 20 people and 200 people is not significantly different. Hence, there is a lot of room for my profits to grow. Thirdly, I could tap into the internet to deliver training to more people all over the world. With these growth opportunities, I believe the probability for me to increase my profits over the next ten years is very good!

You do not have to be an expert to identify growth opportunities. You just have to ask how else the companies can do the business to grow their profits. If it is too complex to figure out, you may not want to invest in that business.

These are the five simple rules to looking at businesses. You should at least go through these rules to find out more about the businesses. You should only invest in companies that have the key to survive, competitive advantage and growth opportunities. Do understand the revenue and cost structure to assess the risks related to it. If a company passes all these tests, it should be in your watch list!

Industry Analysis

We could classify all the listed companies into various industries. Before you invest, it is good to understand the profit characteristics and the prospect of the industry. The following are the main industry classifications:

Banking and Finance	Clean Technology	Commodities
Education	Manufacturing	Food
Hotels	Information Technology	Logistics
Medical	Biotechnology	Oil and Gas
Real Estate	Recycling	Retail
Shipping	Telecommunications	Water

Figure 2.1: Main Industry Classifications

Some of the profit characteristics of the industries above are as follows:

Higher Profits Volatility - Certain industries tend to have higher profit volatility as compared to others. Such industries would perform well when economy is booming and they are the first to suffer when the economy is recessionary. Banking and Finance, Hotels and Real Estate industries have this characteristic.

Stable Profits in Good Times - Industries in this category tend to have stable profits when economy is doing well. It is unlikely though for these industries to have exciting profit growth. When the economy is doing badly, profits from these industries are likely to suffer. One reason for such a characteristic is that these industries have many players resulting in stiff competition. Manufacturing, Logistics, Retail, Shipping Industries are usually in this category.

Stable Profits regardless of Economic Conditions - Certain industries are in the business of providing basic goods whereby regardless of good or bad times, there will be demand for it. Their profits would thus be stable regardless of economic conditions. Industries that falls into this category are Commodities, Food, Medical, Oil and Gas, Water, Telecommunication and Education.

Focus on Future Profits - Certain industries focus on creating products of the future. As such, their research and development expenditure can be very high. It is also likely to take longer time to reap returns from these companies. However, the returns can be very high if they are successful in creating a new product with high demand. Investors who want to invest in such industries must prepare for the long wait! Information Technology, Biotechnology, Telecommunication, Clean Technology and Recycling industries would be in this category.

Before you invest in a company, it is important to know which industry it belongs too. Know how the companies perform in terms of profit characteristics and invest accordingly!

Impact of Economic Conditions on Profits

When you understand a company well in terms of what their business is, their business model and their profit characteristics, you would have a good sense of the impact of the economic conditions on their profits. This understanding would enable you to react quickly when you see certain economic occurrence coming. It is probably easier for me to illustrate with some case studies.

Ship Builders vs. Shipping Companies

Even though both of them involve ships, their profit characteristics are quite different. Whatever that affects shipping companies may not have any impact on ship builders. Just by the income pattern of these companies, we can know which company will suffer more during an economic downturn.

Ship builders in essence are doing project works. They bid for projects and once successful, it is likely for them to take one to two years to deliver the ship. They have few customers and the revenue collection is likely to be irregular pending completion of milestones or the ship itself. This is different from shipping companies that collect revenues base on trips, which should be quite frequent and regular. In this case, when we have an economic downturn, if ship builders have already locked in their order books, impact to their profits should be minimal as long as their customers are still able to pay.

However, for shipping companies, their profits are likely to fall almost immediately if the downturn decreases the shipping volume. Hence, for short term, we can see that economic downturn would have immediate impact on shipping companies but not ship builders. Of course, if the downturn persists, profits of ship builders will also fall since shipping companies would order fewer ships from them.

Real Estate Companies

There are different forms of real estate companies, namely, developers, asset managers, construction companies, property owners and REITs. Again, they have different income characteristics and not all of them will perform according to real estate prices.

Take developers vs. construction companies. Developers are product sellers and they obviously will benefit when the real estate prices increase. Construction companies on the other hand may not have the same fate. They are service providers to developers and they bid for projects to construct. Even when the real estate prices increase, they may not be able to increase their prices as they may lose their competitiveness.

REITs are another good example. The mandate for REITs is to buy and hold properties for long term to benefit investors in terms of rental income. Their business model does not include trading of properties. As such, when the real estate prices increase, we do not expect their profits to increase since it is dependent on rental income, and rental is unlikely to vary in the short term. Of course, if the property value increases on a sustainable basis, it is likely for the rental to increase as well. However, it will take some time depending on the rental expiry with every tenant.

Understanding the impact on profits is one of the key skills required for portfolio management. In portfolio management, I always advocate having at least thirty different stocks in a portfolio. Based on empirical studies, this is the number of stocks you should at least have to be truly diversified and hence with the lowest portfolio risk. Many will ask how I monitor these thirty stocks on a long-term basis. One way for me to do so is to look at economic occurrences and assess if there are any impact on my shares. For example, when I read that oil price is going to increase, I will look at my share portfolio to see which of my companies are affected by oil price. I will then re-assess these companies to ascertain if I need to take any action. If not, I will just leave my portfolio alone and look at it only once every six months. Don't forget, we are here to do long term share investing!

Getting an Investment Theme

Let us come to the crux of business analysis, which is getting an investment theme! The main spirit of long-term investment is this: **Look for businesses with potential sustainable profit growth over the next five to ten years. The share price of such companies will increase. At the same time, you can get dividends while holding the shares!**

Having an investment theme is about what you foresee the future is going to be and which companies are going to benefit from it. My personal investment themes are:

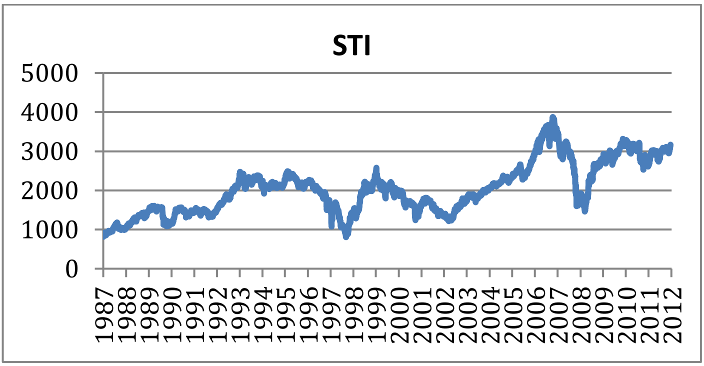
Investment Theme #1: Increased Globalization

I believe that in the next five to ten years, the world will be even more inter-connected. There will be more travelling, more collaboration with people from other countries and many cities around the world becoming major cosmopolitan hubs. When that happens, there will be increased usage of amenities that support globalization and profits for these providers will increase. Some of the industries that I believe will benefit from this trend are telecommunication, hotels, logistics and airline. I do pay special attention to companies in these industries, as I believe they have a good five to ten years ahead of them.

Investment Theme #2: Natural Resource Depletion

The other phenomenon that I see happening in the next five to ten years is the depletion of various natural resources. I foresee that we will have lesser forests, agricultural lands, oil, minerals and various other natural resources. With diminishing supply, prices of these items are likely to go up. Hence, I believe companies that are currently owning these assets or dealing with these assets will be making good profits in time to come.

This is what business analysis is all about! Before I end this chapter, I just want to stress again that choosing a good company, one with potential for sustainable profit growth and healthy balance sheet is the primary activity for long-term investment. Only after shortlisting these companies, we then worry about whether the price is right. The reason for this school of thought is this: If the company is good, even if you bought at the wrong price, over time, you will still gain from your investment.



Data Source: finance.yahoo.com

Figure 2.2: Historical Pricing of Straits Times Index

Taking the Singapore share market for example, as you can see from this chart, the current peak is higher than the previous peak. With inflation and the Asian growth story, I believe that this trend is going to continue. As such, if the company you choose is still around in the next peak and more profitable at that point in time, even if you have purchased the shares at the current peak, it is likely that you can profit when we go into the next peak! (Of course, please avoid buying at peaks!) This is why I always emphasize on buying a good company rather than a cheap company, as the latter may not be around in the next peak!

ABOUT THE AUTHOR

Chua I-Min, CFA is a Regional Investment Trainer in Stocks and Real Estate. He conducts regular classes for the Singapore Stock Exchange (SGX) Academy in fundamental analysis, stock valuation, REITs and property stocks investments. His flagship program which has the same title as this book "*Create a Secondary Income Stream through Long Term Share Investing*" has been well received by retail investors.

I-Min graduated with a Bachelor's Degree in Business Administration with Honours (2nd Upper), majoring in Finance. He continued his education by earning the CFA charter, one of the most sought after professional designation in the global investment industry. Even as a student, I-Min has been applying concepts from text books in the real world share market. He has since honed his investment skills with more than 20 years of share investing experiences.

Professionally, I-Min has more than 17 years of working experience mainly in the investment industry. He was the Chief Operating Officer for A.B. Maximus before his current role. Previously, as a real estate investment professional in Capitaland and subsequently PhillipCapital, he had collectively done investment deals amounting to S$250 million. Prior to that, he was based in China, participating in a successful IPO exercise of a Chinese company in Singapore Stock Exchange.