Sequel to the National Best-Seller
'Secrets of Self-Made Millionaires'

Secrets of Millionaire Investors

How You Can Build a Million-Dollar Net Worth by Investing in the Stock Markets

Adam Khoo & Conrad Alvin Lim

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Also By Adam Khoo

I Am Gifted, So Are You!
Master Your Mind, Design Your Destiny
Secrets of Self-Made Millionaires
Clueless in Starting a Business
How to Multiply Your Child's Intelligence

Dedication from the Authors

Adam Khoo

Dedicated to my Daughters Kelly and Samantha Khoo

Conrad Alvin Lim

For Dad, Wish you could see this

Special Thanks to

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Acknowledgements By Adam Khoo

To my parents Vince, Betty and Joanne who have given me unconditional love and support throughout the years. To my wife. Sally who has been my pillar of inspiration and strength. To my two daughters Kelly and Samantha who make me smile everyday. To my partner, Patrick Cheo, who has been sharing my vision and continually pushing me to the next level. To my partner Stuart for being the ultimate tag team partner for joining me on this amazing mission of empowering lives. To Gary Lee for years of friendship and support. To my trainers Ramesh Muthusamy, Amin Morni, Melvin Chew, Danny Tong, Leroy Ratnam, Freddy Gomez, Candice Koh, Woei Tang, Yuan Yee and Jeff who keep bringing our programs to a higher level through their passion and dedication.

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This book is also dedicated to the hundreds of coaches & Whoosh members who have volunteered their time to continuously come back and coach for the Superkids™, 'I Am Gifted So Are You!™', 'Patterns of Excellence™' and 'Wealth Academy™' programs.

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Acknowledgements By Conrad Alvin Lim

The list of people who have led me to this point is surprisingly short. The faith, trust and encouragement however, is anything but short. These few individuals are the reason any successful person strives to better themselves. They set the bar, raised it every so often, pushed when beliefs were failing, admonished my faults and kept me humble. My expectations were never good enough and they drove me harder. They were always there to support, motivate and encourage. Yet, they did not control, blame or failed in their faith in me. For this, I am eternally grateful.

This book celebrates my comeback and it is fitting that I immortalize the names of those who were responsible for my "return"; Zann for seeing and helping me realize that dreams are possible; Travis for keeping the faith and trust; Kaz for the push, drive and support I needed; Andrew, Angela and Terence for a painless transition; my students who have stayed the cause - Poon, James, Raj, William, Eng Joo, Kareen, Kay Hee, Yam Pheng, Tony, Lay Lee, Tham, Wences and Steven.

For seeing the possibilities, the opportunity and the promise of what I do, I owe everything to Patrick Cheo. I have always respected and admired people with vision and often modeled such outstanding individuals. Working with Patrick has brought that respect to another realm.

My co-writer, Adam Khoo, needs no more accolades. This young man has taught this old man how to re-live my life and be young again. He made me realize how much I wasted and how it could have been so much better. His generosity and sincerity brought back a belief I had lost; that no one could be that genuine and be trusted. His faith and trust has given me this new lease of life which I can never repay. My only regret about Adam is, "Why couldn't he have been born before me?"

Amidst all these thanks and gratitude, the one person I could never have done without and will never want to be without, is my wife Lucy. To say that she kept the faith and trusted in my abilities, does not do justice to the effort, tears, agony, stress, strength, will and determination of this woman.

When everything fell apart, she fought to keep it together. She defended when others attacked. When things were bleak, she made it bright. She made life clear when it went blur. She brought home the bread when I went broke. She is strength when I am weak. She is my laughter when I should cry. She is my angel when I'm in hell. She is mother when I can't be father. Lucy is my wife even when I couldn't be her husband. I love you.

"At times our own light goes out and is rekindled by a spark from another person. Each of us has cause to think with deep gratitude of those who have lighted the flame within us."
- *Albert Schweitzer*

About Adam Khoo

Adam Khoo is an entrepreneur, a best-selling author and a peak performance trainer. A self-made millionaire by the age of 26, he owns and runs three businesses with a combined annual turnover of $20m. He is the Chief Executive Officer of Adam Khoo Learning Technologies Group Pte Ltd, one of Asia's Largest Public Training Companies and Education Group. He is also the Managing Director of Adcom Pte Ltd, an advertising agency and the co-founder of Event Gurus Pte Ltd, an event management company.

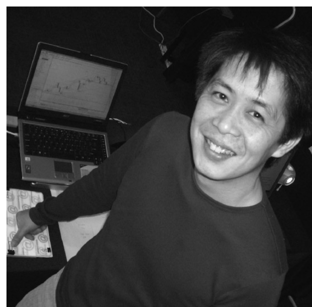
Adam is also the best-selling author of five other books including 'I Am Gifted, So Are You!', 'How to Multiply Your Child's Intelligence', 'Clueless in Starting a Business' and 'Master Your Mind, Design Your Destiny' which was the second highest selling book in Singapore in 2004 and has been on the Straits Times Life! best-sellers list for thirty-six weeks. His fifth book is 'Secrets of Self-Made Millionaires' that was ranked #1 on the Straits Times Life Best-Sellers List.

Adam holds an honors degree in business administration from the National University of Singapore. As an undergraduate, he was ranked among the top one percent of academic achievers and became a pioneer in the Talent Development Program, which is the university's gifted program.

Over the last 15 years, he has trained over 355,000 students, teachers, professionals, executives and business owners to tap their personal power and achieve excellence in their various fields of endeavor.

His success and achievements are regularly featured in regional media like the Straits Times, the Business Times, the New Paper, Lianhe Zaobao, Channel News Asia, Channel U, Channel 8, Newsradio 938, The Hindu, The Malaysian Sun, The Star and many more. 'The Executive Magazine' recently ranked Adam among the 25 richest Singaporeans under the age of 40.

About Conrad Alvin Lim



Conrad, 42, is one of Singapore's few successful Full Time Professional On-Line Traders. He is very sought after for his intimate knowledge of Technical Analysis, Japanese Candlestick application, Sector Rotation and his unique Short Term Pattern Trading and Day Trading techniques. Two years ago, while tutoring students in his 3-room home, he created The Pattern Trader Tutorial and Forum and averaged US$5'000 in monthly profits.

Conrad has since taken residency as an instructor at Adam Khoo Learning Technologies Group and as the Group's Investment Strategist. He conducts his own Pattern Trader Tutorial there and along with Adam Khoo, trains at the center's Wealth Academy™ workshops. Conrad created and runs the Wealth Investor Club, the Wealth Academy™ Investor tutorials and conducts advanced tutorials in private sessions for students willing to pay the premium.

Today, Conrad is growing his portfolio at an average 19.9% a month. In January 2007, his one month profit exceeded US$16,000 with an average of US$1,200 per 12 minute Scalp. He has trained more than 70 students to date and has had no less than 4 who have become full time traders. Conrad's trademark 5DPEG (5 Day Pre-Earnings Game) is a favourite amongst novices wanting to learn to trade and has a 92% success probability. Amongst others, he is also known for his low risk techniques which include the Minimal Risk Entries, PHI-Bonacci Expansion, The Variable Standard 6 and Sector Investing.

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1 Making Money from the Markets

STOCK MARKET

chapter 1

Making Money from the Markets

It is 9.30 pm (Singapore time) and you are watching television at home with your family after a day at the office. You realize that the US market has just opened and you switch on your laptop to check out the latest financial news to look out for stocks that are heavily traded.

You log into your online brokerage account and make a purchase for a stock, which you know, will make a major price move. You continue watching television and have a lively conversation with your spouse.

An hour later you check your account and find that you have made a profit of US$350. With a click of the mouse, you close your position and decide to go to bed. Within a month of consistent trading (with both gains and losses), you find yourself earning an extra side income of US$3,000–US$5,000, more than what you earn at your day job.

Imagine another scenario. You diligently save 15%–20% of your income from your day job and consistently invest it in a portfolio of carefully selected stocks. Within three years you find that the money you have saved has more than doubled in value. While your friends are struggling to meet their monthly expense obligations and pay off debts which they have accumulated over the years, you enjoy the security of a cash flushed bank account and the freedom of pursuing your dreams!

Is all this just a fantasy? Can this really be possible? The answer is a definite YES! Thousands of well-informed and well-trained investors all over the world are making hundreds, thousands and even hundreds of thousands in extra income every year from the convenience of their home. The explosive growth of the Internet, online brokerage accounts and investor education materials has empowered individuals like you and me to take our financial destiny into our own hands.

The investment opportunities previously available only to high net worth individuals and professional money managers are now at our fingertips. In this book I am going to show you how you can access world stock markets and invest in a whole range of financial assets that can grow your wealth at returns of 12%–500%, no matter which direction the markets take! You will be amazed at how you can make money when stocks go up, go down or even when they move sideways.

Adam Khoo's Journey as a Value Investor

Hi! My name is Adam Khoo and it is my privilege and honor to have this opportunity to share with you the secrets which myself, and hundreds of past graduates and fellow investors have in creating wealth from investing in the markets.

My maternal grandfather was the one who first introduced me to the world of stock and shares. Since I was aged 15, he would give me (as well as his other four grandchildren) shares in Singapore & Malaysian listed companies as Ang Pows (Red Packets), during the Chinese Lunar New Year.

My grandfather believed that giving shares instead of the customary cash would teach us about the importance of saving and investing. Since I was too young to have a brokerage account, my mother held them in trust for me. I was then able to start actively selling and buying more shares through her account.

At about the same time, I started reading and got very interested in self-development books written by motivational gurus like Anthony Robbins (Unlimited Power), Bob Proctor (You Were Born Rich) & Napoleon Hill (Think & Grow Rich). After being exposed to their inspirational stories about the power of human potential, I started to get really motivated to achieve exceptional success & wealth in my life as well. One of my first big goals was to earn my first million at the age of 26! This goal was especially inspired by reading about Anthony Robins, a former janitor and a high school dropout who became a millionaire at the age of 25.

There were two important lessons about wealth that made the greatest impact on my life. The first lesson was that in order to become wealthy, I had to learn how to use my passion & talents

to create multiple streams of income. The second important lesson was that my wealth did not just depend on how much I earned, but rather how much I was able to save and invest. It was through the combined teachings of my father, my grandfather and these gurus that I learnt about the importance of being frugal. I learnt that in order to become rich, I had to learn to invest a lot more than I spent. And so, I developed the philosophy of delayed gratification, one of the most important ingredients to my financial success.

Empowered and inspired, I started thinking of numerous ways I could begin making money as a student. After working as a part-time Disk Jockey (DJ) for a mobile disco company, I started a mobile disco business, which I ran on weekends and during my school holidays. I also made money through giving motivational talks to students, teaching them the skills and strategies for scoring 'A's in their school. My business ventures are explained in greater detail in my earlier two books 'Secrets of Self Made Millionaires', and 'Master Your Mind, Design Your Destiny'. Pretty soon, I found myself making close to $2,000-$4,000 a month… not bad for someone who was still studying.

A Little Bit of Knowledge can Kill

Inspired by 'get rich' books like 'Think and Grow Rich' and 'The Richest Man in Babylon', I diligently saved my money and invested it all into Singapore and Malaysian stocks. These books taught me that in order to become rich, we had to invest in high growth assets to benefit from the power of compound interest.

Unfortunately, many of the stocks that I started buying started falling in price. After two years of saving my hard earned money, I found that instead of my money growing, it had fallen in value by more than 30%! Some of the stocks I bought even went bust or got suspended, losing me my entire investment. I became confused and frustrated. What did I do wrong? Investing is supposed to make me rich but instead it caused me to lose my hard earned money.

It did not help that friends and relatives told me that the stock market was a legalized casino and that buying stocks was as good as gambling. Frustrated and angry that I was 'conned' by these 'get rich' books, I decided to sell whatever stocks I had left and deposited

the proceeds into my bank account. For the next two years, I stayed away from the stock market, preferring to put my money in safer investments like insurance policies and fixed deposits.

Learning from the World's Greatest Investor

However, after a while I soon began to realize that if I did not find a way to make my money grow at a higher rate of return, I would never make my first million. I started searching for more answers and clues as to how people made money through their investments. It was then that I stumbled across a book called 'The Warren Buffett Way-By Robert Hagstrom'.

The book re-counted how Warren Buffett (the second richest man in the world) made over US$52 billion purely through investing in US equities. Through his stock picking skills, he managed to grow his money by 24.7% consistently for over 50 years, doubling his fortune every 3.4 years. Amazed and re-inspired, I decided to learn how Buffett managed to create such consistent success in an area where I met such failure.

When I started reading about the mindsets and strategies employed by the world's greatest investor, I finally realized why I lost my money earlier on. I had broken all the fundamental rules in investing and did not follow any of the steps required to buy winning stocks of great companies.

While what many of the earlier wealth books said were true (i.e. that investing was the key to wealth), the wealth principles they expounded were much too general. It did not provide sufficient information on the essentials of successful investing. I realized that a bit of knowledge no matter how good, can sometimes be very dangerous.

At that time, I had no idea of how to identify high growth companies, analyze financial reports, determine the financial stability of a company or how to value the true worth of a stock. I merely bought stocks based on the advice of brokers and friends or based on the fact that a stock was widely publicized and talked about. No wonder I lost money!

I set myself a goal of learning everything that was necessary to become a successful investor. I learnt that successful investors identified

a high growth & stable company by analyzing its income statements, cash flow statements and balance sheets. I learnt the skills of how to determine a stock's intrinsic value and to only buy it when its price was temporarily down and below its true worth. Using this method known as value investing, I started identifying stocks of undervalued companies and started purchasing them confidently (you will learn exactly how to do this in chapter 4).

In 1998-1999 (when I was still in University) I bought stocks of highly profitable local (Singapore) companies like SIA, OCBC, DBS and Keppel Land. Because of the economic recession, the stocks were selling at ridiculous prices that were less than half of their true worth. Sure enough, within 6-12 months, when the stocks recovered, I had more than doubled my investments and made back all my previous losses.

It was later in 2002 that I learnt how to invest in the dynamic US stock market. Because the US market was still recovering from the great stock market decline in 2000, I had the opportunity again to buy great companies like Nike (Symbol: NKE), Pepsico (Symbol: PEP), Johnson & Johnson (Symbol: JNJ) and Berkshire Hathaway B Shares (Symbol: BRK.B) at prices that were below the true value of the stock. Within 12 months, I had again more than doubled my investments. I was on a roll!

Learning to Double My Money in Days

While I was pretty happy with my own investing success, I was totally blown away when I saw friends of mine who were able to double their money not in a matter of months, but in a matter of days and weeks!

They did it not by buying stocks that were undervalued, but by buying 'Options' on stocks that were being aggressively pushed up by strong market sentiments. Excited and amazed, I started learning the art of 'momentum investing', 'Technical Analysis' and 'Options Trading' by reading books & attending seminars by momentum experts like George Fontanills, William O' Neil and Terry Bedford. Using these additional investment strategies, I learnt how to further increase my investing profits within an even shorter period of time (you will learn how to do this in chapters 5, 6 and 7).

As a result of spending hundreds of hours and thousands of dollars investing in my financial education, I have today the great fortune of being able to make over $150,000–$180,000 in profits every year from investing. It may not seem like a lot to many professional investors, but bear in mind that I am a part time investor. I spend over 90% of my time running my businesses and speaking in seminars throughout the region.

I would like to share with you another even more inspiring story about the power of investing. The story about how my co-author and co-trainer (for Wealth Academy) Mr. Conrad Lim made his fortune in the markets is one that is very different from mine. While I make most of my money from my businesses and invest it for higher returns, Conrad uses investing strategies to create a monthly income for himself. Not only did he build his entire fortune purely through investing, but he used it as a tool to recover from financial bankruptcy. Here is his story…

Conrad Lim's Journey: How A Former Bankrupt Now Makes US$5,000-US$7,000 A Month Trading in the US Markets

Not so long ago, I was a struggling middle-aged nobody with a wife and two small children to feed. Like so many others, mine was a tired and often heard story of the under-qualified, over-experienced and hard-up forty something that we read about ever so often.

I got out of my ugly shoes by realizing that the ones who really care are the ones who really put in an effort to help. For some people, this help never came. So I looked in the mirror and asked myself who really cared the most? The answer was right in front of me. And if I really cared for myself, then the only person who could help me… was myself.

In 2001, I took the last big hit of my life when I became a bankrupt. It was the result of a string of events that led me to that point in my life. Looking back, I believe that all those events happened for a reason and that reason was to lead me to the point in my life in which I now stand.

Three Major Failures in Five Years

The first failure came about when I was the Executive Producer of Singapore's second best production house. I was headhunted and

made an offer that was flattering, to say the least. I was soon raking in the big bucks and living the high life. I upgraded my car, bought a bigger wallet to accommodate more credit cards and decided to start a family. Then it happened.

The lesson I took from that experience was never to be ignorant of the company's bottom line. In my capacity, it was not my job or responsibility but in the end, I was left high and dry, out of work, in debt because my cards were heavily saddled with company expenses and expecting our first child in a couple of months. The company's failure became my problem.

My second failure arose when I was again headhunted and paid a handsome salary to be the General Manager of a once leading leisure and travel group that became defunct. Although I can conveniently blame the Asian Financial Crisis for the closure of my division, I could have done more, in hindsight, if I had been more qualified and educated about managing such a business. I could also seek solace in the fact that in spite of any effort, the group was doomed anyway. But the result was the same; I was again out of work and expecting our second child.

The difference now was that I was getting more expensive to hire as my experience and curriculum vitae was getting more and more impressive. I was also demanding an income to maintain my growing family and affluent lifestyle (which I had become too accustomed to) and the constant need to keep up with the image I had built for myself.

Naturally, those opportunities never came and I decided to go into business for myself. The business was a resounding success and I had to cope with this growth. So I hired more staff and expanded within a year in anticipation of more business. I spent money I had not collected and didn't have. I became more ambitious and grew ever more careless. I turned an ignorant eye to the basic rule of business (which I felt was someone else's responsibility) and neglected my cash flow.

By the end of 1999, recession was evident again. My company's debts ran high and I compounded my impending fate by personally guaranteeing on several large debts. By the year 2000, I could not afford to pay out salaries and my staff walked out. I could not collect on some of the outstanding invoices owed to my company as these

companies were also in dire straits and were about to wind up. The realization of my failure brought on my first and only nervous breakdown and I had become suicidal. All my so-called friends were nowhere to be found. It was the most traumatic experience I would never want to re-live.

Biting the Bullet & Declaring Bankruptcy

Finally, after listening to my wife's advice, I decided to put my pride aside and took the painful decision to bite the bullet and to (gasp!) downgrade. We sold the car and took the bus. We squeezed into a three room flat and sold off our precious things that we didn't have space for. We adjusted our lifestyle and prepared for a life of poverty. Finally, she advised me to take bankruptcy as an option as opposed to a life in debt.

It was the worst thing I could do but the best advise I ever had. Looking back, I would not be writing this book had I not been forced by my wife to swallow my pride and grovel for a living. And that is just what I did.

As a 36-year old former Managing Director, former General Manager of a leading leisure group, former Executive Producer of the country's (and possibly region's) second most successful production house and former top independent Producer, I was now over experienced, under-qualified, approaching middle age and worst of all, bankrupt with over $170,000 in debt. Who would hire me now, in the middle of a full-blown recession?

> 'Success is not about how hard you can hit but how hard you can GET hit and still keep moving forward'
> – Rocky Balboa in the movie 'Rocky Balboa'

Picking up the Pieces and Starting All Over Again

I decided that if no one would give me a job, then I would just have to create one for myself. I went back to my roots and picked up several books on design and taught myself how to edit video and audio. As I learnt this new skill, several old clients from the past kept

faith in my abilities and kept a constant flow of work coming to help me out. I churned out the work from my humble home and ran my small freelance business with low or no cost. The wife, needless to say, became the breadwinner and sole motivation for my comeback.

One of the clients to bring a steady flow of work in for me was none other than my co-writer, Adam Khoo. I soon learnt, by producing a lot of Adam's materials, the importance of self-belief and the power of a positive mindset. I learnt that while I could not change the past, my destiny was within my control. I thought very hard about my future and started to set the goal of not only paying back my debts & getting discharged from bankruptcy, but to become a millionaire.

After setting these huge goals, I realized that at the rate I was going, there was no way I was going to achieve financial freedom. If I continued to run my one-man design operation, it would have meant working well into my retirement. But as things were, it was already tough as a 40-year old competing with twenty-odd youngsters in a fast shrinking (media) market; I had to completely rethink my life. But there was no other way I was going to bring the bacon home because after 20 years, media production was all I knew.

Investing: The Answer to My Financial Freedom?

That was until I did a video project about online investing and trading with Options. The idea of being an investor grabbed my imagination. I spoke to my wife, Lucy, about it. I showed her the material I was working on and how easy and affordable it could be to become a full time trader. The promise of becoming a millionaire and improving the life of our family and our future generations, the dream of having a financially free lifestyle and the simplistic approach to the method was just too good to resist.

Experiencing Initial Failure…

After attending our first trading workshop in an intensive, mind-crunching four days, Lucy and I quickly funded our first account with US$5,000 and began trading. As luck would have it, profits came fast and easy and our account grew by 20% in our first week of trading. We then hit our first few losses and told ourselves that this was normal in trading.

The losses accumulated and still we lived in denial. Ignorance became a reality check when we wiped out almost all of our capital and whatever profits we had made. So we re-funded our account with another US$5,000 and tried again. I attended several more trading workshops and picked up more strategies. Still, the losses kept mounting.

'You always pass failure on the way to success'
– Mickey Rooney

We couldn't figure out why, after paying so much for these workshops and working so hard to stick to the rules, we were still losing money. I began to wonder if the claims of making money from investing were nothing but a big pipe dream.

Our savings were running thin, my media work was getting affected and the workflow had slowed to accommodate my trading workshops and trading at night. My health took a dip because of the late trading hours. My marriage was strained and my family was getting affected by my mood swings and short-tempered flares. This was not how I dreamt it would be. Things had taken a turn for the worse and the dream was becoming a nightmare.

Learning from Mistakes & Changing My Strategy

After four months and over US$10,000 in losses, I stopped trading and took some time away from the market. A friend suggested that I read Alexander Elder's books "Trading for a Living" and "Come Into My Trading Room". That led me to pick up more books on investing and trading.

After reading these books and learning the true ins and outs of investing, I finally realized why I was losing money. It was not that making consistent profits from the stock market was not possible. It was that the investing workshops I had attended had not adequately equipped us with the essential basics that were so necessary to an investor's success. The workshops did not teach us how to thoroughly analyze a company's profitability and financial stability (known as fundamental analysis) as well as the essentials of understanding market psychology towards a stock (known as technical analysis).

> 'Good Judgment Comes From Experience, And Experience Comes From Bad Judgment'
> – Barry LePatner

Basically, the workshops run by many of these self-professed gurus gave just enough information for you to get all excited and kill yourself in the market. Like Adam said earlier on, a little bit of knowledge can kill. How on earth did I expect to pick up something in four days and believe that it would be so easy to accomplish something that others have taken years to build?

Getting Back to Investing Basics & Doing Whatever it Takes to Succeed

So I decided that I would do whatever it took to master the art of investing. I would first build a solid foundation by learning everything that needed to be learnt about investing in the stock market.

I formally retired from the media business knowing that I could only achieve my goal if it was a "must" (something Adam taught me). There was no turning back and failure was not an option anymore.

I hit the libraries, bookstores and Internet to suck out as much information as I could gather. I studied the finer points of Technical Analysis, Pattern Trading, Momentum Trading, Sector Investing and even Japanese Candlestick Analysis. I got to know and modeled some real traders who gave valuable insights into the world of online trading. I started working out and running again and got my physical fitness back. With that, I got my self-esteem back up on the high.

US$50 a Day… Small but Consistent Profits

After three months of hard work and self-study, I was able to formulate a simple and affordable trading strategy which allowed me to consistently earn US$50 on single Options for every trade in less than five days. Soon enough, I was averaging US$300 a week with success in five out of every six trades. This first strategy that I had developed is known as the 5-Day Pre-Earnings Game and you can read about it on www.wealthacademyinvestor.com.

This small but initial success gave me the confidence and motivation to learn even more and to work even harder. I began to learn and test more advanced strategies such as 'Sector Rotation', 'Intra-Day Scalping' and 'Momentum Trading', which you will learn in the chapters that follow.

> 'It takes a long time to bring excellence to maturity'
> – Publilius Syrus (~100 B.C.)

Making US$5,000–US$7,000 of Consistent Profits a Month

After more than a year of extremely hard work, I began consistently earning between US$5,000- US$7,000 a month in trading profits. And my earnings keep increasing as time goes by and my experience builds. In fact, I made US$7,000 within the first six trading days of the year (2007). By the end of the month (January), I took back a total of US$15,000 in profits. I post all my trades (both wins and losses) on my BLOG and website. You can view them at www.wealthacademyinvestor.com.

After being a bankrupt for more than five years (since 2001), I finally made enough money to pay off all my debts and applied to my official assignee to be discharged from bankruptcy. That moment was one of the sweetest memories in my mind. As of the 29th March 2007, I was officially discharged from bankruptcy.

GOVERNMENT OF SINGAPORE

OFFICIAL ASSIGNEE
SINGAPORE

THE BANKRUPTCY ACT
(CHAPTER 20)

IN THE MATTER OF SECTION 125 OF
THE BANKRUPTCY ACT (CHAPTER 20)

LIM SNG KWANG CONRAD ALVIN
NRIC NO.
IN BANKRUPTCY NO 602372 OF 2001

CERTIFICATE OF DISCHARGE BY OFFICIAL ASSIGNEE

In the exercise of my powers under Section 125 of the Bankruptcy Act (Chapter 20), I hereby discharge the abovenamed person from bankruptcy from the date hereof.

Dated this 29th day of March 2007

SARJIT SINGH
OFFICIAL ASSIGNEE

When news of my investment skills spread within the investing circles, other traders (both amateurs and professionals alike) urged me to teach them everything I knew. They were willing to pay me "kopi lui" (coffee money) to make it worth my effort. So every Saturday, I would conduct what became known as 'The Pattern Trader Tutorial' where seven students would be cramped in a small room in my three-room HDB flat. I am proud to say that many of them have gone on to experience a lot of success and have shown their appreciation by continuously recommending more students to me.

Partnering with Adam Khoo

So how did I end up becoming a co-writer of this book and a co-trainer in Adam Khoo's famed Wealth Academy Program? Well, when Adam heard of my success both in investing and in training other professional traders, he was so impressed that he invited me to join his company as an investment strategist. When he found that my investing skills could add tremendous value and synergy to his work, he asked me to join him as a trainer in the Wealth Academy Seminar and to create the Wealth Academy Investor Mentorship program. It has indeed been a dream comes true for me.

My Message to You!

I hope that my story has inspired you to remember that no matter how difficult and unfair life can seem at times, you should never ever give up hope. You must believe in yourself and continue to dare to dream of the best for you and your family. Your dreams will inspire you daily to take action and to keep moving forward. Also, expect failures and setbacks to come because they will.

However, it is not what happens to you that determine your destiny. Rather it is what you choose to do about it that makes the difference. When you choose to keep learning from your mistakes and changing your strategy , you will eventually find a way to realize your dreams.

It is my prayer that as you read this book, you will move on to bigger and better things. I know it can be done. I know it will be achieved. I know, because not so long ago, I was a struggling middle-aged nobody…

What You can Expect from This Book

Are you ready to learn all the investing secrets that will allow you to achieve your financial dreams as well? Well, get ready because in the chapters that follow, you will be learning all the strategies and techniques that you need in order to conquer the markets.

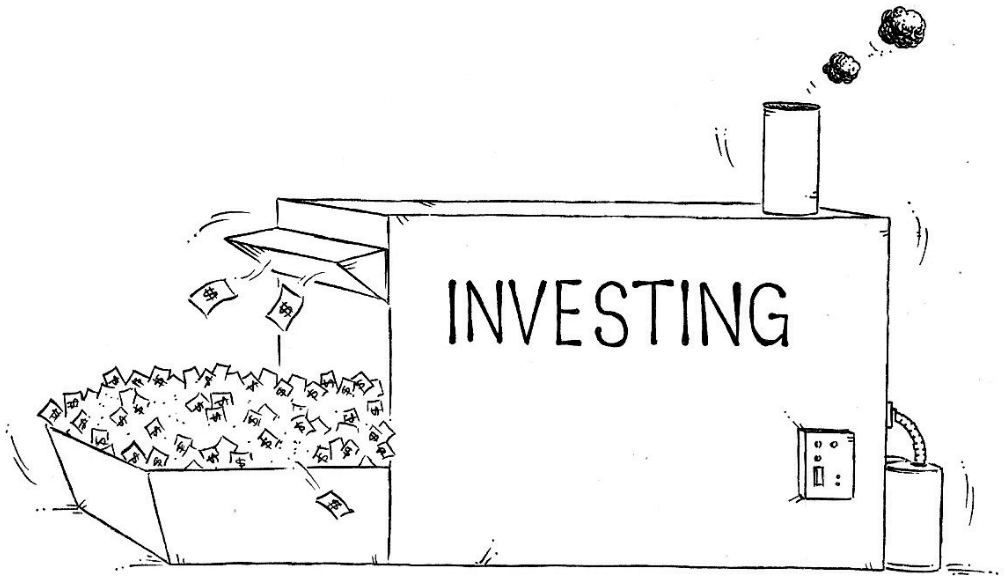
Let me warn you that this is not an airy-fairy book with lots of theories and general ideas. This is not one of those books that are loaded with bullsh*t telling you what you need but not really telling you how to do it. At times, we will be going into very technical details that may seem overwhelming at first (especially if you don't have a background in finance).

This is because we do not want to be pulling any punches. We want to teach you everything that you will need to get starting in investing safely. But don't worry, we have written this book so that you will be able to easily understand and grasp the important financial concepts.

So, get ready to take your financial intelligence to a new level and take charge of your financial destiny now…

The Power of Investing in Building Your Wealth

2


INVESTING

chapter 2

The Power of Investing In Building Your Wealth

Do you wonder how you can ever make your first million without quitting your fixed salaried job? Have saved up a tidy sum of money with no idea how to make it grow? Are you looking for ways to build an additional source of income from home? If your answer is yes to any of the above questions, you will be amazed at what the world of investing can do for you!

Short-term investment strategies can provide you a way of generating an additional source of monthly income to eventually even replace the income you earn from your full time job. Just like Conrad Alvin Lim, you could make a very comfortable living by earning US$5,000-US$7,000 a month as a full time investor (starting with a capital of just US$5,000).

The great thing about investing is that you could also potentially build a million-dollar net-worth while earning an average income from a fixed salaried job. I know many of my past graduates are well on their way to making their first half-million, simply by learning to invest and multiply the money they have saved from their humble civil servant paying jobs.

And if you are already making a high income as a high-flying senior executive or as a business owner, investing can help you multiply your wealth even faster. Although I have made most of my money from my businesses, it is through the investments I made that have enabled me to become financially free much earlier than expected!

I believe the ability to invest is one of the most powerful skills you can ever learn in your life! Unless you learn how to consistently save and let your money work hard for you, you will never be able to build the wealth to provide the security and freedom that your family deserves. This is why so many intelligent and highly educated

people end up broke and frustrated after years of hard work, even in high paying jobs.

This is where this book comes in. In this chapter and the ones to come, you will learn the most closely guarded investment secrets used by both amateur and professional investors to build your wealth through the power of investing.

Investing is Highly Risky?

When you mention the word 'investing' to most people, especially when it comes to the stock markets, reactions of caution and fear often arise.

I have heard my friends or relatives say…

'I lost half my savings when the stock market crashed'
'Every time I buy a stock, it seems to go down'
'I should have kept my money in the bank instead'
'Investing is risky, you can lose your capital'
'Buying stocks is like gambling'

This aversion to investing is compounded by the fact that we were taught by finance courses, banks and financial advisors that 'high risk leads to high return'. In order to earn high returns, you must be a risk taker! And since most people don't like the idea of taking big risks, they never ever aspire to achieve high returns with their money.

As a result of past painful experiences and well-intentioned advice from ignorant friends, many people have developed a phobia for investing. They believe that 'investing is too risky' and 'it's safer to keep my money in the bank.' And so they resign themselves to earning measly returns of 2%-3% from their fixed deposit accounts.

Consequently, they have lost out on one of the most powerful wealth building tools available, and the opportunity to retire young and wealthy. What's worse is that by not investing, these people actually experience the devaluation of their hard earned savings from the effects of inflation Thinking they have saved enough money to retire comfortably after twenty years of hard work, they realize too late that everything around them has doubled or even tripled in price! Think about that $9 movie ticket that used to cost $3 in the

1980s. Inflation would almost guarantee that you will be paying more than $27 to watch a movie twenty-five years from now. Similarly, maintaining your home and a car would cost three times more than it costs today. Is your money growing as fast as prices are rising? By not learning how to invest, it is almost certain that you will end up struggling financially in your twilight years. That is what I call truly risky! Not investing really leads to 'high risk and no return'.

When You Know What You are Doing, Investing is Low Risk & High Return…

Is it really true that investing is risky? The answer is… it depends. The risk in an activity very much depends on the level of competence of the person doing that activity. For example, is it risky to drive a car? Well, if you have never gone for any driving lessons and have no idea how to read road signs, engage the gears or to use your side-view mirrors, then there is a high chance that you could get yourself badly hurt or even killed. However, if you have a thorough understanding of how to drive well, then driving is a low risk activity.

Similarly, investing is risky when you don't know what you are doing. The scary thing is that the majority of people who invest their hard earned money in the stock market do not know what they are doing. Many people who buy shares of companies have little or no knowledge of how to invest. They are like that driver who has no clue about how to work the gears or the rules of the road. This is because you do not need to take a license or be qualified to be an investor. Just about anybody can do it!

Most amateur investors do not even have a basic understanding of the economic cycle and how interest rates and oil prices affect the global economy & the stock market. They have no clue as to where and how to read financial reports that will impact the stock markets. Most have very little financial & accounting knowledge and do not know how to value the worth of the company's shares they are buying. In fact, I am often shocked when I hear of people who invest in a company without even understanding what business the company is involved in, let alone understand the company's business strategy.

In the highway of investing, over 70% of investors (mostly the general public) are driving around without the basic skills of motoring! This is why many of them crash and burn their hard earned money. For the majority of people out there with little financial competence, investing is truly high risk and maybe high return (depends a lot on blind luck). To me these people are not investors but gamblers. For such people, I would strongly advise them to learn how to drive or to leave their money in the bank or under their pillow!

When you have a thorough understanding of the stock market & the rules of investing, then investing is no longer risky! When you know exactly what you are doing, you can achieve extremely high returns, with very low risk!

'Risk Comes From Not Knowing What You Are Doing'
– Warren Buffett, World's Greatest Investor

In fact, it may surprise you to know that the greatest investors in the world are NOT risk takers. They are in fact, very risk averse. It is because of their strong financial competence and thorough understanding of the stock market and business that they are able to achieve very high returns, at very low risks. Warren Buffett, the world's greatest investor, who achieved 24.7% returns per year for the last 49 years is known to be extremely risk averse. His Rule #1 in investing is 'Never Lose Money.' His second rule in investing is 'Don't Forget Rule #1.'

I follow the exact same philosophy. Again, many people perceive that because of the businesses I have started and the investments I make, I am a risk taker. In reality, I too am 'risk averse' and 'security' is one of my highest priorities. However, because of my financial intelligence, I am able to confidently identify and invest in stocks and business where I have a 95% chance of making a high return and even if I am wrong, the loss is minimal.

By reading this book and understanding all my concepts and strategies that I will share, you too will be able to confidently achieve a high level of returns from your investments with very little risk. While the rest of the crowd have chosen to walk (because of the fear

of driving on the highway of investing), you will learn how to read the financial road signs and to confidently drive the vehicle of wealth and accelerate towards your financial goals.

Which Investment Vehicle Gives the Highest Return?

There are many financial vehicles that you can use to drive yourself towards your financial goals. So, which vehicle is the fastest and is the most powerful? Let's take a look at which investments have achieved the highest returns over the last fifty years.

Investment	Annual Compounded Return	Years to Double
Inflation (US)	3.7 %	
Inflation (SG)	3.2 %	
Fixed Deposit SG (3-year)	1.5 %	
US Treasury Bills (3mths)	4.5 %	16 years
Gold	4.1 %	17.5 years
US Corporate Bonds	6.4 %	11.25 years
US Stocks (S&P 500)	12.08 %	5.96 years
Singapore Stocks (STI) (19-year history for the STI)	10 %	7.2 years

**Stock market returns are calculated on an annual compounding return basis with dividends reinvested.*
**Abbreviations: US: United States and SG: Singapore.*
S&P 500: Standard & Poors 500 Index. STI: Straits Times Index.

From the table above, you can see that inflation has historically raised prices by over 3.2% a year. This may seem like a small figure but compound it over twenty years, and the price of a product would double! You have to at least make sure that the vehicle you choose should overtake the 3.2% inflation rate and keep the value of your money intact!

While there are so many financial vehicles you can choose to invest in, such as corporate bonds, gold, fixed deposits and government bonds (also known as treasury bills), there is no doubt that stocks emerge as the clear winner over time! Investing in the US stock market would have seen your money grow by an annual compounded average of 12.08% per year. At this rate, your money would be doubling in value every 5.96 years. A $10,000 investment would grow into $97,850 in 20 years (10 times) and into $306,000 in 30 years (30 times).

A Bond is an 'IOU' in which you (the investor) agree to loan money to a company (company bond) or government (government bond) in exchange for regular interest payments (known as the coupon) and the eventual repayment of the capital at maturity. Companies and governments issue bonds of various borrowed amounts, interest rates and time to maturity which you can buy.

Of course it does not mean that stock market prices actually increased by 12.08% every year for the last fifty years. In some years, the stock market may have come down by 20% while in some years it may have increased by 30%. Over the long-term, your money would have grown by an average of 12.08% per year.

Investing in the Singapore stock market would have seen your money double every 7.2 years, at an annual compounding rate of 10% per year. If you are wondering why this figure is higher than the one presented in my previous book, it is because the spectacular performance of the Straits Times index in the year 2006 really pushed up the historical annual average.

How Stock Market Performance is Measured

When we say that the US stock market grew by 12.08% annually, does it mean that every single company's stock listed in the United States increased in value by 12.08%? Of course not! In fact, there are over 9,000 companies listed on the three main US stock exchanges (New York Stock Exchange, NASDAQ and American Stock Exchange). Some of these stocks may have increased in price by 500% (like Google Inc) while others may have dropped in value by 80% (i.e. Ford Motor Company). The performance of a stock market is measured by an Index (or many indexes). An index is a selected portfolio of stocks that is used to represent the whole stock market.

The US stock market is represented by many indexes, the most popular of which is the Standard & Poor's 500 Index (S&P 500). This index consists of 500 of the largest companies in the US stock market and represents over 70% of the total stock market value. The index value is calculated by taking the weighted average price of all these 500 stocks and it represents the overall performance of the whole US stock market. So, when we say that the US stock market increased by

an average of 12.08% a year, we are referring to the average price of the 500 largest companies! Another popular index used to measure the performance of the US stock market is the Dow Jones Industrials Index (DJI). The DJI consists of only 30 of the largest companies in the US. As such, it may not be as representative as the S&P 500 Index.

Similarly, the performance of the entire Singapore Stock Market (there are over 620 companies listed) is measured by the Straits Times Index, which consists of 55 of the largest companies listed on the Singapore Stock Exchange. So when we say that the Singapore stock market increased by 10% annually, we are referring to the weighted average price of the 55 largest companies here. So what does all this mean? It means that if you buy the stocks of all the 500 companies in the US (in the same proportion of the Index), you would make an annual compounded return of 12.08%! In the next chapter, you will learn exactly how to do this with as little as a US$140 investment! The reason why most people lose money in the stock markets is because they buy the wrong companies that go down in value!

The good news is that with the strategies you will learn from this book, you can achieve a lot higher returns than the 12.08% annual growth of the Index! As well-informed and financially competent investors, our aim is not to achieve the same performance as the index, but to beat it! In fact, Indexes are used as a benchmark that all professional investors aim to beat. Any idiot can achieve a 12.08% or 10% return simply by buying the S&P 500 Index or the Straits Time Index respectively. In fact, you are going to learn this 'idiot proof strategy' in the next chapter. By learning how to identify and buy only the best companies in the market (i.e. like Google Inc), you can confidently achieve a return that is much higher than the overall market.

US Market or Singapore Market?

While there are definitely great investment opportunities in the local Singapore market and while I do have some money parked in some great Singapore listed companies, I still find myself making the best returns from the US market. This is why you will find that most of the strategies and examples presented in this book are very

much based on trading in US stocks and options. However, the same methods can be easily applied to the local Singapore market or any other stock market for that matter. There are three main reasons why I prefer investing in the US markets.

1. A Much Wider Selection of Stocks & Financial Derivatives

The first and most obvious advantage of investing in the US markets is the much wider selection of stocks that you have to choose from. There are over 9,000 listed companies in the US compared to just over 620 companies on the Singapore bourse. So at any point of time, it is much easier to find a great stock that fits all the winning investment criteria and that could triple in value. US stocks tend to also have a much higher potential to increase in value simply because the companies you invest in have a much higher potential for sales and earnings growth (the US consumer market is huge). Finally, with many of the companies stocks having options written on them, you are able to use a much wider range of trading strategies that allow you to make money even when the stocks go down or don't move in price at all. You will learn all these exciting strategies in the chapters to come.

2. Higher Liquidity and Volume

The other major reason why I prefer to trade US stocks is because of the high volume of securities that are traded every day. US stock markets also have 'market makers' who will buy the stocks you want to sell or sell the stocks you want to buy if there is no one else willing to. In this way, you are guaranteed to be able to buy and sell the stocks you want!

Besides a handful of popular and actively traded stocks on the Singapore bourse, there are some great investment instruments that are very hard to buy or sell simply because of the lack of volume. For example, I always recommend that people buy the STI ETF (Straits Times Index Exchange Traded Fund) which tracks the performance of the Straits Times Index (STI). Some of you may remember reading about it in my previous book 'Secrets of Self-Made Millionaires'. If you had bought the STI ETF a year ago (early 2006), you would have made an annual return of over 26% as the STI surged to an all time high of 3,000 points. The trouble is that it is very difficult to buy or sell this powerful security as the average daily traded volume is less than 10 shares per day!

3. Superior Research Data & Tools at Much Lower Costs

Making the right investment decisions depends very much on the timeliness and comprehensiveness of the research data available. In the US, hundreds of stock research sites provide you with every conceivable piece of research information you need to make a good decision and many of them are provided for free. In fact, you have access to the same exact information that is used by professional money managers. At the click of a mouse, you can find out a stock's 10-year history of earnings, profitability, borrowings, valuation as well as the ratings of hundreds of stock analysis. In the local market, the availability of research data is extremely limited and even when you can find it; you have to pay a high price for it.

The Great News is…

In the past, it was very difficult and very expensive for an investor in Singapore (or any other foreign country) to think of trading in the US markets. High transaction costs and the inconvenience of going through a local broker (which closed when the US markets opened) made it not worthwhile. However, with the explosive growth of the Internet and the emergence of online discount stock brokers, it is just as easy and cheap (in fact cheaper) to access the US stock markets as compared to the local markets!

How the Power of Investing Can Turn You into an Automatic Millionaire by Just Saving 10% of Your Income

Now, you may be thinking that a 12.08% annual return from the stock market may not sound very exciting. However, when allowed to compound over a period of time, it will turn small amount of capital into huge returns!

Imagine if you were to earn an average of $36,000 a year ($3,000 a month) for your entire working life of thirty years. This is assuming you start working at age 25 after graduating from university and retire at age 55. The total income you would receive would be $1.08 million ($36,000 x 30 years). So the good news is that you would already be earning a million dollars in your lifetime, without any help from me. The bad news is that if you are like most people, you would probably spend most of the money you earn and a whole lot more. You would end up at the end of thirty years with nothing much left.

What if you were to just invest 10% of that income a month (i.e. $300) into the US stock market Index and allowed it to compound annually at 12.08%, how much would it grow to? Using a financial calculator, you will find that $300 a month invested at 12.08% compounded annually will grow to $939,106! Isn't that amazing! Just by investing 10% of your income, you get back almost all of that $1 million which you earned in the first place. This is possible because of the amazing power that compound interest (returns) can have on small amounts of capital over a long period of time! And the best part is that it takes very little investment knowledge to do this. All you

have to do is to invest consistently in the Index. Once again, you will learn exactly how to do this in the next chapter.

I know that some of you are probably thinking that you don't have thirty years to wait to make your first million. You probably want to achieve financial freedom within the next 10–15 years or less!

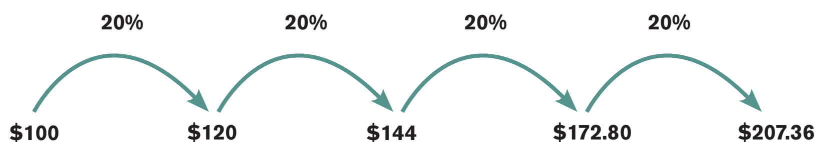
The great news is that with some hard work and the savvy stock picking skills you will learn throughout this book, you will confidently be able to achieve a minimum of 15%–25% compounded annual returns on your investment. In fact, by utilizing the power of options trading which you will learn in chapters 6 to 8, you can easily make 100%–500% return on your invested capital at times (although I don't suggest you throw everything into this strategy). Using this strategy was precisely how Conrad manages to make average of US$5,000–US$7,000 a month (his record is US$14,852.25 in January 2007) with less than US$5,000 in capital. That's a 100% return in a month. Look at the table below and you will see how various investment amounts will grow at different rates of return over different periods of time.

Invest at 15% Compounded Annual Return					
Amount Invested		**5 yrs**	**10 yrs**	**20 yrs**	**30 yrs**
$300	a month	$26,202	$78,905	$398,122	$1.69m
$500	a month	$43,671	$131,509	$663,536	$2.82m
$1000	a month	$87,342	$263,018	$1.33m	$5.63m
$1500	a month	$131,013	$394,572	$1.99m	$8.45m
$2000	a month	$174,684	$526,036	$2.65m	$11.26m
Invest at 20% Compounded Annual Return					
Amount Invested		**5 yrs**	**10yrs**	**20yrs**	**30yrs**
$300	a month	$29,611	$103,293	$742,858	$4.70m
$500	a month	$49,351	$172,155	$1.24m	$7.84m
$1000	a month	$98,703	$344,311	$2.48m	$15.68m
$1500	a month	$148,055	$516,466	$3.71m	$23.51m
$2000	a month	$197,407	$688,622	$4.95m	$31.35m
Invest at 25% Compounded Annual Return					
Amount Invested		**5 yrs**	**10yrs**	**20yrs**	**30yrs**
$300	a month	$33,409	$135,369	$1.4m	$13.14m
$500	a month	$55,683	$225,615	$2.33m	$21.9m
$1000	a month	$111,366	$451,230	$4.65m	$43.79m
$1500	a month	$167,049	$676,845	$6.98m	$65.69m
$2000	a month	$222,733	$902,460	$9.31m	$87.58m

Understanding the Awesome Power of Compounding

Let's explore a bit deeper into the meaning of compounded returns and understand how it actually turns small sums of capital into huge amounts of money. Compound return is achieved when you invest a sum of money at a particular rate of return. Instead of taking out the profits earned after a year, you add it back to the principal sum and reinvest this larger sum. So the next year, the rate of return is on a larger principal sum. This continues until the returns a year become greater and greater!

For example, say you invested $100 into a stock that gave you an annual return of 20%. At the end of one year, you would have $120. Instead of taking out the $20 profit, you leave it inside for another year at the same rate of return of 20%. At the end of the second year, your investment would grow to $144. The next year, it would grow to $172.80 and on the fourth year, it would grow to $207.36!



In less than four years, your initial investment has doubled in value!

How Long will it Take Your Money to Double in Value?

Albert Einstein, the greatest genius of our time once remarked that compound interest was the greatest mathematical discovery ever made! He came up with a formula called the Rule of 72. It states that if you take 72 and divide it by the Annual Percentage return, it will give you the number of years your investment would double!

For example, in the previous case, the percentage return was 20%. So if you take 72 ÷ 20 = 3.6 years you will see your investment of $100 double to $200 in 3.6 years.

The power of compounding was Warren Buffett's secret weapon in creating the second biggest fortune in the world, purely by investing in US stocks. Warren achieved an average annual return of 24.7% for 49 years! This means that his money doubled every 2.9 years (72 ÷24.7). He turned an investment of $100,000 in 1956 into $4,200,000,000 ($4.2 billion) today.

Four Powerful Investing Strategies to Multiply Your Money

Now that I have excited you with the theories and possibilities of multiplying your money, the questions you are probably asking are, 'how do I get started?' 'How do I actually achieve a 12.08% annual return by buying all the stocks in the Index?' 'How can I achieve a 20–25% return a year by beating the market? 'How do I select the right stocks?' 'How long will it take for me to achieve the returns I want?'

Well, strap on your seatbelt and get ready because I am going to share with you a whole range of strategies I use to multiply my money at millionaire returns. Through my own course of learning to invest over the years, I have found that there are many very different philosophies and strategies that experts use to select stocks to achieve above average returns.

The funny thing is that some of these strategies contradict each other. Where one expert says that you should thoroughly understand and love the business behind a stock that you buy, other experts say that you should treat stocks as commodities and trade them without any need for understanding the business. Some experts have made their fortune purely by studying a company's fundamentals (i.e. financial strength, profitability & business potential) while totally ignoring its historical price trends (i.e. technical analysis).

At the same time, I know gurus who have made millions purely through the analysis of a stock's price movements and reading the psychology of the market, while ignoring the company's fundamentals. Some experts believe in buying and holding their investments over the long-term while others believe that you should be in and out of an investment within a few weeks! Some investment experts like Warren Buffett believe in buying undervalued stocks only when they

are shunned by the market and then selling them for huge profits once they reach their fair value. This is also known as the Contrarian Strategy (you do things contrary to what the investment communities are doing). Other gurus like William O' Neil tend to buy stocks of over valued companies that are being aggressively accumulated by fund managers, with the anticipation that the stock price will rise dramatically in value because of the hype around it. This is known as a momentum strategy.

After studying and testing the many schools of thought (with my own money), I have discovered that all these different strategies WORK, when thoroughly understood and applied properly. Today, I use a whole range of different investment strategies myself, depending on whether I am looking for a quick intraday gain or a longer-term return over a year. In all, I will share with you four of the most powerful growth strategies I use to make millions of dollars in the markets (presented in the figure below).

As you go down the scale, you can see that each subsequent growth strategy allows you to make a lot more profit within a shorter period of time. However, does this mean that your risks increase? Well, like I said previously, the level of risk depends on your level of financial intelligence. If you are like most investors who have low financial intelligence then each new strategy becomes much more risky. However as you increase your financial intelligence, the risk remains the same. Although each subsequent strategy becomes more powerful, the level of financial expertise required to execute it properly also increases.

Growth Strategy 1: Buying Markets & Sectors

The first growth strategy you will be learning in chapter 3 would be on how to achieve the same returns as the whole US stock market or Singapore Stock market by buying the market indexes such as the S&P 500 index, Dow Jones Index, Nasdaq composite Index and the Straits Times Index. This is the most basic strategy that all novice investors should start off with. Executing this strategy successfully involves the lowest level of financial competence but can make you consistent annual compounded returns of 10%–12.08%. The holding period for such investments would be usually over one year or longer.

You will also learn how to buy sectors or industries that may be performing very well within the whole stock market. The US stock market (which is made up of over 9,000 stocks) can be grouped into sectors such as health care stocks, financial stocks, utility stocks, energy stocks and so on. Hundreds of stocks within a sector can be further divided into different industries. For example, within the huge financial sector, stocks can be further grouped into insurance stocks, bank stocks, asset management etc… At different points in time, one sector may be outperforming other sectors and even outperforming the entire market as a whole. So during times when the US market as a whole may be drifting sideways, you can actually invest in a particular sector (e.g. Energy) that is doing extremely well.

Growth Strategy 2: Value Investing

In chapter 4, you will further increase your level of financial intelligence by learning to select specific stocks of individual companies that would outperform the general market and even the hottest sectors. Value investing is the strategy employed by Warren Buffett, the world's greatest investor and second richest man. In value investing, you will learn to buy high performing companies at a fraction of what they are worth. In other words, you will learn how to buy great companies when they are undervalued and to sell them for a huge profit once the market realizes its true value. This strategy has consistently made me profits of 15%–25% annually!

Growth Strategy 3: Momentum Investing

This next strategy will allow you to achieve much higher returns (of more than 25%) within a much shorter period of time (3–6 months). Momentum investing involves finding the hottest stocks that are ready to make great gains.

Momentum stocks tend to already be priced above their fair value. However, because of the entire market's optimism about the stock's potential, these stocks tend to increase significantly in price within a very short period of time before they are overbought and come tumbling down (this is when you sell and make huge profits).

Growth Strategy 4: Options Trading

Finally, you are going to learn the art of how to make 100%–500% returns on your money from as short as one day to a maximum holding period of 3 months. This final strategy requires you to have the highest level of financial competence and skill. This strategy is known as trading (as opposed to investing) and it involves the use of buying (or selling) stock options.

Trading is different from investing in a few ways. Investing usually involves making money by buying a stock and predicting that it will increase in value over a few months to a few years. However, in trading you are able to make profits whether the stock price moves up or down and you usually enter and exit a trade within a very short period of time. You will learn how to trade options in chapters 6 and 7. However, before you can start successfully applying all these strategies, your mind must first be conditioned to think in a certain way. You must adopt…

The Psychology & Habits of Successful Investors

Very often what sets average and successful investors apart is their psychology or their way of thinking. Although all master investors use very different strategies and investment tools that may even contradict each other, they all share the similar psychological makeup that makes them successful.

Here are seven of the most powerful success habits of successful investors.

1. Buy On Strict Rules & Not Emotions

All successful investors have developed a time-tested and proven system for selecting, buying and selling investments in a way that makes them money consistently. They always buy and sell securities based strictly on a set of clearly defined rules or investment criteria. For example, Warren Buffett will only buy a company if it has shown consistent earnings growth over five years, has little debt, has a high return on equity, has a strong management team and is selling at a price that is way below the company's intrinsic value. If a stock does not meet every single criterion, he does not buy!

Successful investors never allow their decisions to be swayed by their emotions or by the advice of other people. For example, many successful investors have a rule for selling their investments and cutting their losses once their investments fall 10%-20% below their purchase price. The moment this happens, they sell without thinking twice. They never let fear, pride or ego get in the way.

On the other hand, most average investors (who keep losing money) do not have a system for investing. They buy and sell based on the opinions and advice from their friends or relatives (who are usually broke too). Their decisions are usually driven by the emotions of fear and greed, instead of a set of well-defined criteria. For example, when they see a stock rallying like there is no tomorrow, their greed for quick profits and their fear of losing out drives them into buying, even if the stock may have lousy earnings or may have broken other rationale buying criteria. Sure enough, the stock come tumbling down the moment they make their purchase, causing them to lose their hard earned money.

And when the stock's price falls 10%-20% below their purchase price, they do not follow smart selling rules and cut their losses early. Instead, their ego and pride gets in the way. Their fear of making a loss makes them hold on to their losing position. They say to themselves 'it will come back again' or 'it cannot go down any lower'. Sure enough, the stock sinks lower and lower until they are forced to sell at a massive loss.

2. Admit Your Mistakes Early.

Successful investors know that no matter how great their investment strategy is, it is never hundred percent accurate. They know that no matter how smart or experienced they are, they too make mistakes.

The difference between successful investors and average investors is that the former admit their mistakes early. Once successful investors know they have made a wrong investment decision (the stock price moves against them), they will sell and minimize their losses immediately. On the other hand, most average investors hate to admit that they made a bad decision. They will start giving excuses and hold on to their bad investments in dissent. As a result, they make huge losses that wipe out any gains they may have made in the past.

> 'It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong'
> – George Soros, One of the World's Most Respected Investors

As quoted by legendary billionaire investor George Soros, master investors know that they may be wrong from time to time. However, if they minimize their losses by admitting their mistakes early, they will still make huge profits from the gains they make from their good investments. For example, take a look at a typical profit & loss chart from an average investor.

Table 1: Typical profit & Loss Chart of an Average Investor

Stock	Buy Price	Quantity	Sell Price	Profit/Loss	Return
A	$50	500	$80	$15,000.00	60.00%
B	$50	500	$75	$12,500.00	50.00%
C	$50	500	$23	($13,500.00)	-54.00%
D	$50	500	$66	$8,000.00	32.00%
E	$50	500	$23	($13,500.00)	-54.00%
F	$50	500	$15	($17,500.00)	-70.00%
			Total	**($9,000.00)**	**-70.00%**

For simplicity and easy calculation, I have standardized the cost price and quantity of all six stocks in this hypothetical portfolio. As you can see, most investors would make some good investments and some bad ones. Typically, the losses from the bad investments would wipe out all the profits made from the good investments, sometimes even resulting in a net loss (a bracket signifies a loss).

Table 2: Cutting Losses Early Can Make You a Decent Profit Even When You Are Right Half the Time

Stock	Buy Price	Quantity	Sell Price	Profit/Loss	Return
A	$50	500	$80	$15,000.00	60.00%
B	$50	500	$75	$12,500.00	50.00%
C	$50	500	$45	($2,500.00)	-10.00%
D	$50	500	$66	$8,000.00	32.00%
E	$50	500	$45	($2,500.00)	-10.00%
F	$50	500	$45	($2,500.00)	-10.00%
			Total	**$28,000.00**	**18.67%**

Even if a great investor gets half his stock picks wrong (which is highly unlikely), he would still make a profit if he knows how to sell his losing investments once it falls 10% below his purchase price (i.e. $45). As you can see from table 2 below, even if you were to make 3 bad stock picks out of 6, you would still make an 18.67% return by cutting your losses early. So can you imagine how successful you can be when you learn how to pick 8 out of 10 great stocks and minimize your losses on the 2 bad ones?

This is why US presidential investment advisor Bernard Baruch once said; "Even being right three or four times out of 10 should yield a person a fortune if they have the sense to cut losses quickly."

3. Become An Expert and Don't Rely on Experts

The third success habit of successful investors is that they only make investments in areas in which they have an expertise. Great investors make investment decisions with a high probability of success not because they are lucky or because they have a crystal ball. Their successful track record comes from the fact that they have a tremendous depth of knowledge and expertise in their area of investments.

All this comes from hours of research and study. Warren Buffett is so good at being able to pick companies that will increase in value simply because he has a very good understanding of how businesses work. He will spend hours reading the company's annual reports and dissect every price of information before making a decision. The reason why Warren Buffett makes very few bad decisions is because he only invests within his circle of competence. He only invests in businesses which he knows and understands inside out. The reason why Buffett avoided investing in any Internet businesses during the dotcom boom of 1998-2000 is because he did not understand their business models. By so doing, he avoided one of the greatest market crashes in recent history.

> 'The market, like the lord, helps those who help themselves. Unlike the lord, the market does not forgive those who know not what they do'
> – Warren Buffett

On the other hand, the average investor tends to invest in stocks & other financial securities without having a thorough understanding of what they are doing. I am usually shocked to hear that people actually buy shares in a company without doing thorough research on the stock's financial history, growth prospects, management strategy and historical price patterns. Instead, they buy on advice from 'other experts' who they believe have all the right answers. Remember, that

making money in any field of endeavor is never easy, whether it is in business, Internet marketing, sales or investing. If you want to be a great investor, you must be willing to spend the time to learn thoroughly and be an expert in the subject of investing!

4. When there is Nothing to Invest in, Don't Invest

One of the main reasons why many professionally managed funds are not able to consistently beat the S&P 500 is because they are required to invest 80% of their funds into the market at any one time. If they were to hold more than 20% of their assets in cash, they will be criticized for not putting the money to work. The problem is that it is not always a good time to invest and you will not always find investments that match the investment criteria of a successful investment. By constantly having to be invest in the market; they suffer as much losses from bad investments as they do enjoy the gains from good ones. The trouble is many amateur investors make the same similar mistake and are quick to jump into the first investment that comes along.

One thing I have noticed about all great investors and traders is that if they cannot find an investment that confidently meets all their criteria, they do not invest or trade. Successful investors have the patience to wait indefinitely until they find an investment with a very high probability for success and a low risk of loss. Only then do they make the confident decision of taking a large position.

5. Take 100% Responsibility for Your Results

As a successful investor, you must have the attitude of taking full responsibility for the results you have acquired, both success and failure. Lousy investors tend to give excuses and lay blames whenever they lose money. Their usual responses include: 'my broker gave me the wrong advice', 'the market went against me' or it's just bad luck'. As a result of not admitting that they made a wrong decision, the average investor does not learn from his mistakes to become a better investor. Successful investors are the first to admit that they made the wrong decisions and used the wrong strategy. They learn from their mistakes, become wiser and move on to their next investment.

6. Be Passionate About Investing

If you have read my two other books 'Master Your Mind, Design Your Destiny' or 'Secrets of Self Made Millionaires', you would know that passion is the most important ingredient for being successful in any field of endeavor. The world of investing is no different. If you do not enjoy looking at charts and studying financial data from annual reports, then you will never be a successful investor. If you are purely investing with the motivation to make a quick buck then you will probably be like the majority of people who will lose money and give up.

> 'I have enjoyed the process (of investing) far more than the proceeds, though I have learned to live with those, also'
> – Warren Buffett

Tiger Woods did not chose to play golf because of the money; it was because he loves the game. Celine Dion (or any other successful artiste for that matter) chose to become a singer not because of the money, but because she loves to sing. Similarly, Warren Buffett started investing in stocks not because he was motivated by materialism; it was because he loved investing. This is evident by the fact that after making US$42 billion in the markets, he still lives in a $31,500 house that he bought 30 years ago. And what did he do with most of his wealth recently? He gave it all away to charity. In fact, Warren Buffett once remarked in a speech to his shareholders, 'we should pay to have this job!'

So why is passion so important to success? Remember that to be good in anything, you have to be an expert in it! The only way you can be an expert in something (i.e. investing) is if you live, breathe, eat and sleep investing. When an investment guru listens to the weather forecast, he thinks of how it will impact oil prices and energy stocks. When he shops at the supermarkets, he notices the best selling products and the companies (stocks) that sell it! When he reads the news to find that interest rates are rising, he thinks about how it will affect bond prices and financial stocks. The only way you can be totally focused in something is if you truly have a passion for it.

7. Reduce Risks & Maximize Returns

As I mentioned at the very beginning of this chapter, the average investor believes that in order to make high returns from investing, he has to take big risks! The successful investor on the other hand is usually risk averse. He believes that returns are not related to risk. Instead, risk comes from not being an expert at what you are doing. The master investor will only invests if he finds an investment with a very high probability of success, one with very high potential upside with limited downside. So, only invest when with minimal risks and very high returns.

Now that you have a clear understanding about the basics of investing, let's get this party started by diving into the first growth strategy…

3

The Idiot-Proof Way of Making Money

THE MARKET

chapter 3

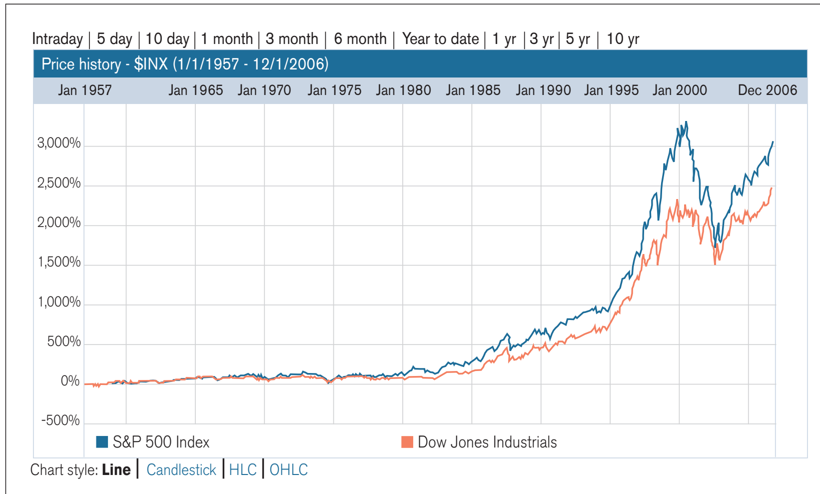
The Idiot-Proof Way of Making Money

In this chapter we are going to explore the first and the most basic strategy for making money in stocks. I call it the idiot-proof way of making guaranteed returns. That's right! This strategy requires very little financial expertise and just about anybody can make almost risk-free compounded annual returns of at least 10%–12.08%. The only skill you really need is 'patience'. I suggest that you start off with this first strategy of 'buying the market' if you are a complete beginner to investing.

Before you label me as 'crazy' for thinking that risk-free annual returns of 10%–12.08% are possible, I want you to take a look at the historical performance of the US stock market over the last 50 years. As mentioned in the last chapter, stock markets are measured by indexes. In the case of the US market, the S&P 500 Index (SPX) and Dow Jones Industrial Index (INDU) are the two most common portfolio of stocks used to represent & measure the performance of the entire market. Do recall that the S&P 500 Index takes the weighted average price of the 500 largest stocks in the US market while the Dow Jones Index takes the weighted average price of the 30 largest companies in the US. Since the S&P 500's portfolio of stocks makes up over 70% of the total markets' worth (capitalization), it is more representative of the whole market.

Chart 1: 50 Year History of the US Stock Market (1957-2006)

Screen capture from www.moneycentral.com



"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

What is the first thing you notice about the stock market's performance? While stocks may be volatile in the short-term, it always goes higher and higher in the long-term. The stock market is always on a long-term uptrend. This means that each low point is higher than the previous low and each high point is higher than the previous high!

Over the last 50 years, the S&P 500 achieved an annual compounded return of 12.08% with dividends reinvested. Does this mean that the stock market increased by 12.08% every year? Of course not! In fact, in some years, the S&P 500 dropped by 45% while in some years, it doubled in value. In the long run, your money would have increased by 12.08% annually.

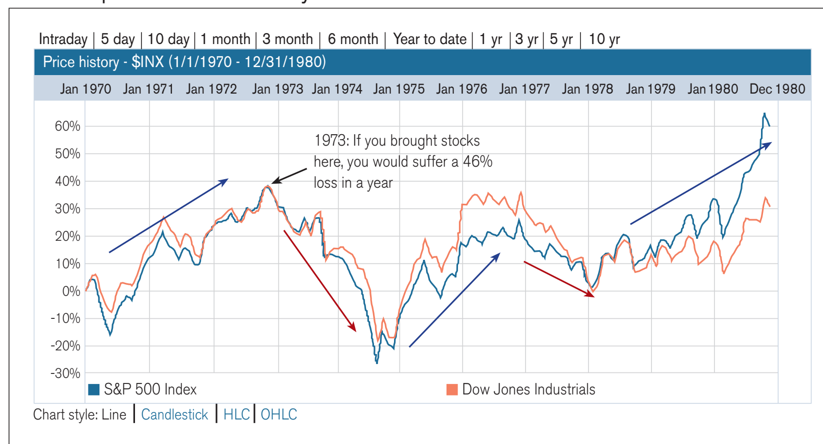
Now, will the stock market continue to increase in the next 50 years? Will this uptrend continues? Well, not only do most people think it will continue, but many believe that it will increase at a faster rate! You can see from the chart that the stock market grew much faster from 1990-2000 than it did from 1980 to 1990. At the same time, 1980-1990 performed much better than 1970-1980. So, the best years of the stock market may be yet to come!

What is the rationale for stock market prices to keep going higher and higher? Well, stock prices are driven by company profits. The higher the profits of a company, the higher its shares will be priced. Over time, inflation pushes prices of a company's products and services higher. For example, a cup of coffee today costs twice as much as it did ten years ago and you can bet it will be even more expensive in the year 2016. As the world's population grows and gets richer (especially in developing countries like China and India), there are more and more people that companies can sell their products to. Higher prices at higher volumes result in higher and higher profits for companies. This continuous growth in earnings over time keeps pushing stock prices higher.

Now take a look at the stock market's performance over a shorter-term period of ten years (1970–1980) in Chart 2 below.

Chart 2: 10-Year History of the US Stock Market (1970-1980)

Screen capture from www.moneycentral.com



"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

As you can see, in the short-term, stock prices randomly move up and down. In fact, from 1970–1980, the market rallied up three times and went down two times. If you had bought stocks at one of the peaks in 1973; you would have had a massive heart attack when the market plunged by more than 46% the next following year (1974).

Half your savings would have been wiped out if you had got scared off and sold everything you had at the bottom. This is exactly why most ignorant investors lose their life savings in stocks and find it extremely risky. However, had you understood how stock markets worked in the long-term and held on to your stocks, you would have gotten a 20.7% return within five years! Better still, if you had bought even more stocks when it hit the bottom in 1974, you would have doubled your money in five years' time (1980). If you held on to your stocks till today (2006), your money would have increased 22 times! A $45,000 investment would make you a millionaire today.

Now let's take a look at the actual gains and losses from the S&P 500 year-on-year. Take note that these annual returns do not include the dividends you would have received by holding the stocks. So in actual fact, the figure is much higher than this.

Table 1: 50 Years of Gains & Losses from the S&P 500 (1-year periods)

1957	-13.40%	**1967**	+20.09%	**1977**	-11.50%	**1987**	+2.03%	**1997**	+31.00%
1958	+36.90%	**1968**	+7.66%	**1978**	+1.06%	**1988**	+12.39%	**1998**	+26.67%
1959	+8.03%	**1969**	-11.36%	**1979**	+12.31%	**1989**	+27.25%	**1999**	+19.53%
1960	-3.00%	**1970**	+0.10%	**1980**	+25.77%	**1990**	-6.56%	**2000**	-10.14%
1961	+24.28%	**1971**	+11.67%	**1981**	-9.73%	**1991**	+26.31%	**2001**	-13.04%
1962	-11.80%	**1972**	+15.63%	**1982**	+14.76%	**1992**	+4.48%	**2002**	-23.37%
1963	+18.89%	**1973**	-17.37%	**1983**	+17.26%	**1993**	+7.06%	**2003**	+26.38%
1964	+12.97%	**1974**	-29.72%	**1984**	+1.40%	**1994**	-1.55%	**2004**	+8.99%
1965	+9.06%	**1975**	+31.38%	**1985**	+26.36%	**1995**	+34.13%	**2005**	+3.00%
1966	-13.09%	**1976**	+19.15%	**1986**	+14.62%	**1996**	+16.36%	**2006**	+11.89%

* *Source: calculated from the S&P 500 Index's closing prices from www.moneycentral.com*
* *Does not include dividends reinvested*

From the table, you can see that in a 50-year period, there were 36 winning years and 14 losing years. This means that if you had invested your money in the stock market for a one-year period, your chance of loss would be 14 out of 50 or 28%. Your probability of making money would be 72% (36 out of 50)! Not bad! But, what if we had stayed invested for a minimum of five years?

Table 2: 50 Years of Gains & Losses from the S&P 500 (5-year periods)

1957-1961	+54.87%	**1982-1986**	+97.77%
1962-1966	+12.27%	**1987-1991**	+72.23%
1967-1971	+27.09%	**1992-1996**	+77.62%
1972-1976	+5.26%	**1997-2001**	+54.99%
1977-1981	+14.04%	**2002-2006**	+21.66%

* *Source: calculated from the S&P 500 Index's closing prices from www.moneycentral.com*
* *Does not include dividends reinvested*

From the table above, you can see that there were altogether ten '5-year periods' in the last 50 years and every period returned a positive figure. This means that if you kept your money invested for at least five years, your chance of loss would be 'zero'. Your chance of gain would be 100%! Now, I am not going to go so far as to suggest that investing in ANY five-year period is going to give you guaranteed returns. In fact, if you had invested at the very peak of the dot-com bubble in March 2000, you would still make a very slight loss of 10% after five years (March 2005). However, this is an isolated case as March 2000 was a time when the markets were insanely way overvalued. What I CAN SAY is that when you stay invested for a 5-year period, the chance of loss is negligible, and the chance of gain is very high!

What I am confident of saying is that if you stay invested even longer, say a ten-year period, then the risk of loss is truly 'zero' and the chance of gain is 100%. In table 3 below, you can see that for every 10-year period in history, the chance of loss is 0% and the chance of gain is 100%!

Table 3: 50 Years of Gains & Losses from the S&P 500 (10-year periods)

1957-1966	+73.87%	**1987-1996**	+205.88%
1967-1976	+33.77%	**1997-2006**	101.26%
1977-1986	+125.36%		

* *Source: calculated from the S&P 500 Index's closing prices from www.moneycentral.com*
* *Does not include dividends reinvested*

Key Investing Insights

By studying all this market data, there are two main lessons that we can conclude from.

1. The Market is Volatile in the Short-Term; In the Long-Term, It Always Goes Up

In the short-term, the market randomly goes through up-trends and downtrends, booms and busts. This volatility is what causes loss and fear for inexperienced investors. However, in the long-term, the market will always trend upwards.

Do be cautioned that this principle applies only to the market as a whole (i.e. S&P 500 & Dow Jones) and does NOT apply to individual stocks. An individual stock's price could go down and never come back up!

2. The Longer You Stay Invested, The Lower the Risk

If you had invested in a one-year period, your chance of loss would be 28% and your chance of gain would be 72%. If you had invested in a 5-year period, your chance of loss would have been 0%. Your chance of gain would have been 100%. Needless to say, staying invested for at least 10-years reaps a risk-free return.

In other words, you always win and make money if you hold your stocks long enough.

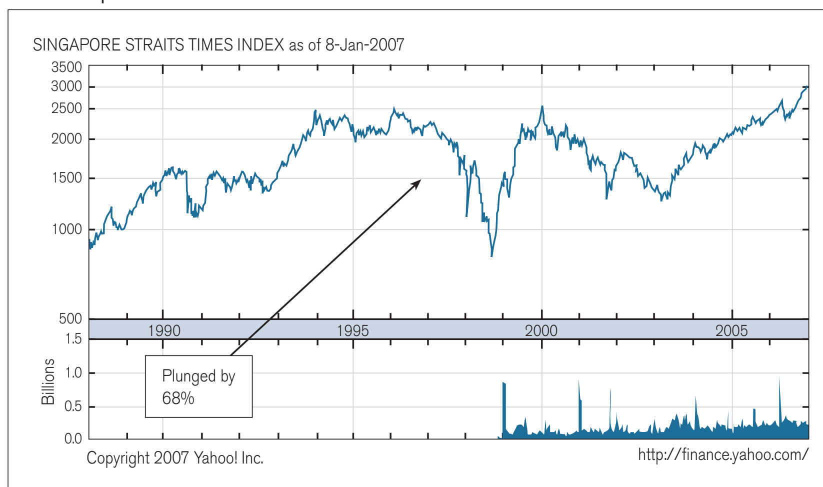
Is The Same True for the Singapore Stock Market?

So, does the same theory hold for the Singapore stock market? Does it always go up in the long-term? Do you always win if you hold long enough?

Let's take a look at the performance of the Straits Times Index (STI) over the last 19 years.

Chart 3: 19-Year History of the Straits Times Index (1987-2006)

Screen capture from Yahoo! Finance



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As you can see, the STI did indeed go through lots of ups and downs over the last 19 years. In fact, from 1996 to late 1997, it plunged by 68%! Again, if you were short-term focused, you would probably have panicked, sold and lost 68% of your investment. If you had held on through the ups and downs, you would have made an annual compounded return of about 10%, including the dividends you would have reinvested. If you had the knowledge that the market would eventually go up again and bought a lot of shares at the lowest point of 1997, you would have enjoyed a total return of 375% over the last 8 years! That amounts to an annual compounded return of 17.96% for seven straight years.

Achieve a 12.08% Annual Compounded Risk-Free Return by Buying the Market for the Long Term

For the last 50 years, the S&P 500 has gone through many ups and downs. However, it has returned an annual compounded rate of return of 12.08% over the period (with dividends reinvested).

So what is the idiot-proof strategy for making money in the markets? Well, simply buy the entire market of stocks (S&P 500 or STI) and stay invested for at least 5–10 years. This way, you will make an annual return of 10–12.08% with little or no risk at all. And as I had revealed in the earlier chapter, by just saving 10% of your income and investing it at the rate of 12.08%, you would become an automatic millionaire at the end of your working career.

So you could be a complete idiot with zero financial intelligence and still end up with a huge net worth when you are ready to retire. The only two skills you need are 'patience' and 'discipline'. For those of you who are looking for much higher returns within a much shorter period of time, you will learn how to beat the market using more advanced investing strategies in the later chapters.

How do I Buy the Market?

The most common question people ask is how they can buy the S&P 500 Index, Dow Jones Index or the Straits Times Index. Does this mean I have to buy the shares of all the top 500 companies in the US or the largest 55 companies in the case of the STI? Well, you cannot actually buy any of the indexes. What you can buy is a mutual fund that tracks the performance of the index. This is known as an Index Fund. To achieve this, the Index Fund holds the same proportion of stocks as the Index itself.

> A Mutual Fund (also known as Unit Trusts in Asia) is an investment vehicle that pools money from many individual investors. A professional fund manager invests and manages these funds into a broad diversification of stocks, bonds and other securities.

The problem is that Mutual Funds tend to have high management fees and are very restricted in the way you can buy and sell them. Today, there is an even better investment vehicle known as an Exchange Traded Fund (ETF). With the explosive growth of ETFs over the last few years (2005–2006), I decided not to even bother with investing in Mutual Funds (unit trusts) anymore.

An ETF is an Index Fund that is listed on a stock exchange and trades intraday (you can buy & sell it anytime of the day just like a stock). In other words, ETFs are constructed like Mutual Funds but

trade like stocks. The best way you can replicate the performance of the S&P 500 and the Dow Jones Index is to buy ETFs that track these two indexes. Here are some of the more common ETFs:

1. Standard & Poors Depository Receipts, Series 1 (SPDR): (Ticker Symbol: SPY)

The SPDR (also known as SPIDER) is an ETF that tracks the performance of the S&P 500 Index. They are listed on the American Stock Exchange (AMX) and you can buy and sell them like the shares of any other company. So by buying one share of the SPDR, you actually 'own' all 500 of the largest companies in the US market.

If you had bought the SPDR shares a year ago (early 2006) when I first recommended it in, 'Secrets of Self-Made Millionaires', you would have paid $126 per share. Currently (Jan 2007), the SPDR shares would be worth $142, giving you a 12.69% return in just one year.

You can buy a minimum of one share through any US online broker or through a local (Singapore) broker, although it will be a lot more expensive. SPDRs are priced approximately 1/10th of the S&P 500 Index. For example, if the S&P 500 Index is at 1400 points, the SPDR will be priced at US$140 per share.

A Word About Ticker Symbols

Every security (stock, ETF, mutual fund, option etc…) or Index has a ticker symbol assigned to it. For example, the ticker symbol for 'Google Inc' is GOOG and the ticker symbol for 'S&P Depository Receipts (SPDR)' is SPY. Whenever you want to trade a security, you have to type in the ticker symbol.

2. Street Tracks Straits Times Index Fund (STI ETF)

If you want your money to grow at the same rate of the Straits Times Index, which measures the Singapore stock market, then you can buy the STI ETF. This ETF aims to track the performance of the Singapore Straits Times Index (STI). They are listed on the Singapore Exchange (SGX) and you can buy and sell them like the shares of any other company.

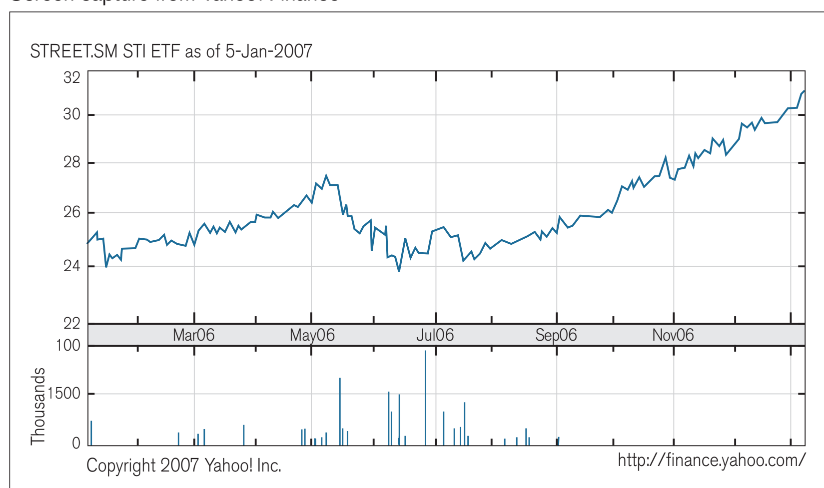
You can buy a minimum of 100 shares through any local (Singapore) broker. The STI ETFs are priced approximately 1/100th of the STI Index. For example, if the STI Index is at 2400 points, the STI ETF

will be priced at $24 per share. The great thing about the ETFs is that it also pays you regular cash dividends of 3%–4% a year on top of the appreciation of the ETF's share value.

As earlier mentioned, if you had bought the STI ETF when I first recommended it in my earlier book in early 2006 (price at $25), you would have achieved a return of over 26% in just one year (current price is $30.69) after collecting the dividends paid.

Chart 4: Stock Chart for STI ETF

Screen capture from Yahoo! Finance



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3. DIAMONDS, Series 1 (Ticker Symbol: DIA)

The DIAMONDS, Series 1 aims to track the performance of the Dow Jones Industrial Index. They are listed on the American Stock Exchange (AMX) and you can buy and sell them like the shares of any other company.

You can buy a minimum of one share through any US online broker or through a local (Singapore) broker, although it will be a lot more expensive. DIAMONDS are priced approximately 1/100th of the Dow Jones Index. For example, if the Dow Jones Index is at 12,314 points, each DIAMOND share will be priced at US$123.14 per share.

When is the Best Time to Buy the Market?

The most common question I was asked during my financial seminars is; 'so, when is the best time to buy into the market?' Well, in general, the best time to buy is 'as early as possible'. The earlier you start investing, the more times your money will have to compound and the bigger your nest egg will be! At the same time, starting early means that your money will have a much longer time to stay invested, lowering your risk to zero.

The Secret of Dollar Cost Averaging

Another very popular strategy used by most investors is known as 'Dollar Cost Averaging (DCA)'. DCA is a method where you invest a fixed dollar amount (e.g. $1,000) into the market at regular intervals (i.e. four times a year) regardless of the share price.

As a result of investing a fixed dollar amount regularly, you will purchase more shares when the stock price is low and you will purchase lesser shares when the stock price is high. Eventually, the average cost of the shares will become smaller and smaller. This strategy lessens the risk of you investing a large amount of money into the market at the wrong time (when the stock prices are high).

Chart 5: Dollar Cost Averaging on the SPDR (SPY)

Screen capture from www.moneycentral.com

"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

For example, let's say you decided to invest $5,000 two times a year (at regular intervals) into the SPDR shares (SPY) as shown above.

On 1 April 2004, the SPY price was $115. So, your $5,000 would have bought about 43 shares.

On 1 Oct 2004, the SPY price was $114.80. So, your $5,000 would have bought about 43 shares as well.

On 1 April 2005, the SPY price was $119.50. So, your $5,000 would have bought only 41 shares. Since the price is now higher, your money will buy less shares.

On 3 Oct, SPY shares jumped to $123. So your $5,000 would have bought only 40 shares. Since the price is even higher, you buy even less shares.

Since you have spent a total of $20,000 buying 167 shares, the average cost of your shares is $119. So at the latest price of $123, you have already made a $4 profit per share! Dollar Cost Averaging is a very safe strategy where you keep the cost of your shares at a historical average level (not too high and not too low). As long as the market moves above its long-term average, you would be making money!

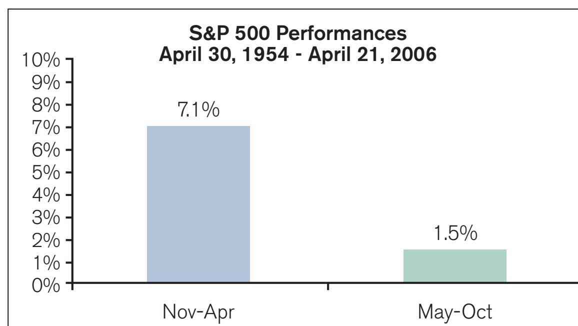
Principles of Buying into the Markets

Of course, you now know that in the short-term, stock markets go through booms and busts, upturns and downturns. So, there are a few signs you can look out for in order to avoid buying into the market when stock prices are generally high. Instead, you can do your best to enter the market when stock prices are generally low so that you can earn a potential return that is even greater than the average 12.08%. Some of these indicators I am going to show you are general guides that can help you improve your returns by a few percentage points!

Principle 1: Buy In The Period of September To October

If you study the price movements of the stock market over the last 50 years on a yearly basis, you would notice certain annual trends that are repeated on a fairly consistent basis.

Stock-price movements historically have been substantially stronger in the 'November to April' period than in the 'May to October' stretch. In fact, the 'November through April' period outperformed 'May through October' 68% of the time over the last 50 years.



Source: Standard & Poors

From the graph above, you can see that from 1945- 2006, the S&P 500 gained an average of 7.1% during the November to April period but gained only 1.5% during the May to October period (this does not include dividends reinvested). This means that majority of gains by the indexes start during the end of the year and last up to the first quarter of the following year. Almost without fail, markets rally start from November to the New Year. This is known as the Santa Claus Rally.

This piece of market trivia would seem to indicate that it would be wise to time your investments in September to October, just before stock prices start their run up. The other interesting trivia is that historically September & October tend to be the worst performing months for the S&P 500. It is during this period that prices tend to be the lowest for the year. Although this doesn't hold true every single year, it happens 68% of the time.

Principle 2: Avoid Buying when the Market is Over-Priced

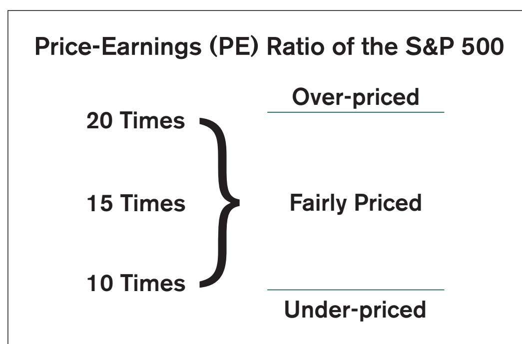
A crude way of measuring whether the stock market is overpriced is to look at the Price to Earnings (PE) ratio of the S&P 500 and the Dow Jones Index. The reason I say it is a crude measure is because there are much more sophisticated ways which I will reveal later. But for beginners, it is a good starting guide.

So, what is the PE ratio of a stock? It is the ratio of the price of a stock to its earnings. For example, if a stock's earnings per share is $2 and the stock is selling at $20, its PE Ratio would be $20÷$2 =10. This means that for every $1 a company's stock is earning per year, investors are willing to pay $10 for that share of stock.

$$\text{Price-to-Earnings Ratio} = \frac{\text{Price Per Share}}{\text{Earnings Per Share}}$$

Theoretically, it means that if the 'earnings per share' remains constant at $2, it would take the investor ten years to break-even on his investment. Why would an investor be willing to pay ten times for what a stock earns per year? The reason is because investors expect the earnings per share to grow every year at more than 10%!

The PE Ratio of the S&P 500 is simply the weighted average PE ratio of all the largest 500 stocks in the US market. For the last 50 years, the median PE ratio of the S&P 500 has been '15 times'. So, if the PE ratio of the S&P 500 is between 10–20 times, the market is considered fairly priced. If the PE ratio is less than 10, the market is considered under-priced. It is at this level that you can confidently buy lots of shares because market prices will eventually rise such that the PE ratio will be in the '15 times' range again.



At the same time, if the PE ratio of the S&P 500 is above 20, the market is deemed to be overpriced and stocks are relatively expensive. It is at this level that you want to be extra cautious as a correction could be on its way to bring stock prices down again. If you had just followed this just one piece of advice, you would not have suffered the horrible fate of most investors when they saw their life savings wiped out when the S&P 500 fell from a high of 1498 points in March 2000 to a low of 815 points in September 2002! That's a 45%

decline in two years. What many investors ignored was that the PE ratio of the S&P 500 was at a mind blowing '45 times' in that fateful year. The rational investor would have known that paying $45 for a stock that only earns $1 is crazy! Sure enough, the market corrected the PE ratio all the way back down to as low as '15 times' again.

You can find the PE ratio of indexes like the S&P 500 Index by going to www.e-trade.com as presented below. From the screen capture, you can see that the Price/Earnings of the S&P 500 Index is 17.9x, which is nearing its overpriced level.

Chart 6: PE Ratio Of The S&P 500 Index

Screen capture from www.e-trade.com

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S&P 500 INDEX (SPX: CBOE)

Last Price	Today's Change	Bid size
1,412.84	0.00 (0.00%)	1,412.84 x0

Open	0.00	Market Cap
Previous Close	1,412.84	Shares Outstanding
Day's Range	0.00 - 0.00	Beta
52 - Week Range	1,219.32 - 1,431.66 6/14/06 - 12/18/06	Dividend Yield
		Declared Dividend
Avg Volume (10 days)	1,579,305,100	Ex-Dividend Date
Price / Earnings (TTM)	17.9x	Dividend Payable Date
Earnings Per Share (TTM)	78.74	

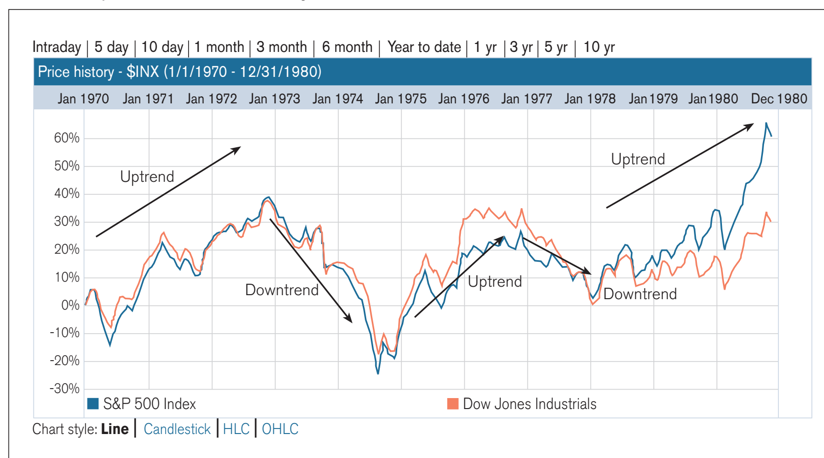
CBOE Delayed Quote
Last Trade as of January 8, 2007

As your agreement for the receipt and use of market data provides, the se
available; (2) do not guarantee that data; and (3) shall not be liable for any

Principle 3: Avoid Buying When the Market is in a Downtrend

Chart 7: S&P 500 Index 10-Year Stock Chart (1970- 1980)

Screen capture from www.moneycentral.com



"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

The above 10-year chart of the S&P 500 Index shows that stock prices move in trends. They can either move in an uptrend, a downtrend or move sideways (known as a consolidation). Once the market is in a trend, it has a tendency to keep moving in that particular direction until a reversal of market psychology occurs. In an uptrend, market sentiment is positive and though prices may pull back once in a while, buyers' optimism keeps pushing prices higher and higher.

Similarly, in a downtrend, investors are generally pessimistic and though prices may move up for a while, the general direction of prices tends to be downwards. Once a market is in a trend, it acts like a current which keeps prices moving in a certain direction.

Understanding this principle of stock market movements, you should never buy stocks when the market is in a downtrend as you will never know how much lower it can go! Only start buying when the market begins to stabilize and move back to an uptrend!

When Is the Best Time to Sell?

Warren Buffett, the world's greatest investor has often said that his favourite holding period is 'forever'! He knows that the longer he

holds his stocks, the larger the compounded effect will be and the lower the risk.

As a general rule, you should stay invested as long as you possibly can and let the magic of compounding do wonders for you. In the previous chapter, you saw how the effect of compounding begins to take off only after a critical period of time has been reached.

A smart investor also knows when to sell off his entire stock portfolio when the market is getting too overvalued and wait for it to correct downwards. When stock prices hit rock bottom, he will move in to buy up his shares at a much cheaper price. By actively moving in and out, you can achieve a much greater return than the 12.08% you will get by just holding on through the ups and downs.

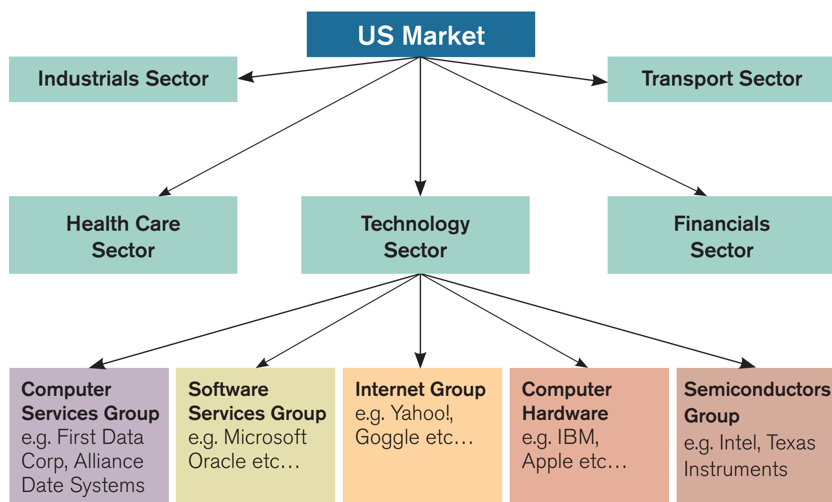
While it is almost impossible to be precise when the market has hit a bottom for you to enter, and exit at its peak, you can follow the earlier mentioned principles so that you won't be too far off. To recap…

1. Sell when PE Ratios Get Way above '25-35 Times'
While it is really hard to tell when the market will come tumbling down, you may want to reduce your stock holdings once PE ratios get to '25-35' times. Remember than the long-term average has been '15 times' and the market will soon correct down to that level eventually.

2. Sell in the Late April- Early May Period
If you want to sell, you may want to move out of the market during the late April to early May period, just before the market ends its year-end rally. In fact a common saying among professional investors in Wall Street is 'Sell in May and Go Away'.

Buying Sections of the Stock Market

Over 9,000 plus stocks make up the entire US stock market, They are divided into sectors such as health care stocks, financial stocks, utility stocks, technology stocks, energy stocks and so on. Hundreds of stocks within a sector can be further divided into different industries. For example, within the huge technology sector, stocks can be further classified into industries or groups like 'Computer services', 'software services', 'Internet companies', 'Computer hardware', 'Semiconductor companies' and so on…



Now, why is it important to know this? Well, investors (especially fund managers) often move billions of dollars throughout different sectors of the market in anticipation of one sector outperforming another during different phases of the economic cycle. For example, when the economy starts slowing down, investors will start to move their money into 'Defensive Sectors' that are believed to be more recession proof.

As a result of money pouring into Defensive Sectors like 'Health Care', 'Consumer Staples' & 'Utilities', most of the stocks in this sector will begin to increase in price a lot faster than the overall market (i..e. S&P 500 Index)! At the same time, stocks in cyclical sectors such as 'Technology', 'Financials', 'Autos', 'Retail' and 'Industrials' will all start declining as money is moved out! This is called 'Sector Rotation'. When a sector is in rotation, it means that money is flowing into it causing most of the stocks to jump in price.

A Crash Course in Economics & Sector Rotation

During an economic slowdown, investors tend to move their money into non-cyclical (also known as defensive) sectors such as 'Health Care', 'Consumer Non-Durables', 'Utilities' & 'Energy'. Non-cyclical stocks thrive in bad times as they are believed to be recession proof. These companies sell products and services that customers have to buy (necessities). As such these sectors will tend to outperform the overall market during economic contractions.

During strong economic growth, investors will move their money into cyclical sectors such as 'industrials', 'technology', 'retail' and 'autos'. These companies tend to produce goods and services whose demand is very dependant on economic prosperity. Therefore, during good times, cyclical sector will outperform the overall market.

Similarly, certain events can cause all the stocks in a sector or industry to go into rotation and outperform the S&P 500 Index. For example, when oil prices rise, almost all stocks in the oil and gas industry (e.g. Exxon Mobil, Chevron Corp etc…) will begin to rise in price. At the same time, rising oil prices will cause almost all stocks in the transportation sector to under perform the broader market (e.g. profits of airlines, train, car companies fall as fuel cost rise).

So, how can you make use of this knowledge? Well, besides investing in ETFs that track the whole market, you can also invest in ETFs that track a particular industry or sector if you know that it is in rotation. Remember that a sector or industry that is in rotation will rise much faster (in price) than the whole market as measured by the S&P 500 Index or the Dow Jones Index.

Popular Sector & Industry ETFs

While there are hundreds of sector and industry ETFs that are listed on the stock exchanges (and their numbers are growing by the day), you can check out some of the more popular ones listed here:

Sector ETFs that You can Invest in…

- Health Care Select Sector SPDR (Ticker Symbol: XLV)
- Materials Select Sector SPDR (Ticker Symbol: XLB)
- Energy Select Sector SPDR (Ticker Symbol: XLE)
- Financials Select Sector SPDR (Ticker Symbol: XLF)
- Industrials Select Sector SPDR (Ticker Symbol: XLL)
- Technology Select Sector SPDR (Ticker Symbol: XLK)
- Utilities Select Sector SPDR (Ticker Symbol: XLU)
- Consumer Staples Select Sector SPDR (Ticker Symbol: XLP)
- Consumer Discretionary Select Sector SPDR (Ticker Symbol: XLY)

Specific Industry ETFs You can Invest in…

- Biotech HOLDRs (BBH) tracks the biotechnology industry
- PHLX Bank Index (HGX) tracks the bank stocks
- Internet HOLDRs (HHH) tracks Internet stocks
- MS Retail Index (MVR) tracks retail companies
- PHLX Housing Index (HGX) tracks housing stocks
- Oil Service HOLDRs (OIH) tracks oil company stocks

Finding Sectors & Industries In Rotation

The good news is that although the stock market goes up, down and even sideways, there will always be a sector of the market that is performing very well. It is often said that there is always a bull market somewhere (as there is always a bear market somewhere). So during periods of times when your investment in the S&P 500 Index may be slowing down, you could also park your money in sector or industry ETFs that happens to be moving into a strong uptrend.

The big question would be, 'how would I know which sector is in rotation or will be going into rotation?' Well, there are many ways of finding out. One way would be to go to finance.google.com and look at the different sector charts (click under Sector Summary) and see how they are performing as compared to the S&P 500 Index.

Chart 8: Stock Chart of Technology Versus S&P 500 Index

Screen capture from finance.google.com

Google Finance images (c) Google Inc. Used with permission.

From the stock chart (chart 8), you can see that the technology sector (i.e. blue line) has been outperforming the broader market (S&P 500 Index) (i.e. red line) over the last six months. The indication to buy the technology ETF would have been in mid-August when the technology price chart started to reverse upwards and overtake the S&P 500 index price chart. This makes sense since cyclical stocks (e.g. technology, auto makers, retail etc…) tend to do well in times of economic growth. When the economy starts to slow, get ready to move your money into defensive sector ETFs.

So, what returns can you expect from investing in a specific sector or industry? Well, if you had bought the Technology Select Sector SPDR six months ago (Jul 2006), you would have achieved a return of 17.5% as compared to just 11% from the S&P 500 ETF (i.e. SPDR). That's pretty significant if you ask me.

Warning: **The final part of this chapter contains strategies that are meant only for experienced investors and those with deeper pockets. If you are a novice, you may want to skip it and go on to the next chapter and read it 6 months later when you have gained more experience.**

However, if your curiosity is really killing you then you may read it at your own risk…

Strategies to Turbo-Charge Your Returns in the Markets

Would you be amazed if I told you that I have been making over 36% in annual returns by just buying the market indexes? So, how is this possible if the indexes have only been returning only 10%–12.08% in compounded returns? The answer is by using a couple of powerful strategies such as CFDs (Contract for Differences) and Technical Analysis to turbo-charge my returns.

> Technical Analysis is the process of studying securities (e.g. stocks) by analyzing statistics generated by market activity, such as past prices and volume. In so doing, you can identify patterns that can accurately predict future price movements.

Before you get all excited, let me throw in a few words of caution. The strategies I am going to share next are not recommended for novice investors. In fact, I strongly suggest you do not attempt to replicate what I am doing unless you first attend my Wealth Academy live training or any other credible investment seminars or workshops.

When executed improperly, investing in CFDs can be extremely risky and you could lose even more than your entire investment capital. However, when thoroughly understood and properly executed, the combined use of CFDs, technical analysis and economic forecasting can give you super high returns with minimal risks. Although this strategy is found in the chapter on 'the idiot proof way of making money', you need to have a good knowledge of investing to apply this.

Strategy 1: Using CFDs to Boost Your Rate of Return

I use a financial instrument known as Contract for Differences (CFDs) that allow me to buy huge amounts of the S&P 500 Index using only a small amount of capital. In fact, with CFDs, I can buy US$10,000 worth of the S&P 500 Index by just putting up a capital of 7.5%. In this case, I just need an initial investment of US$750 to control US$10,000 of the S&P 500 Index.

What are CFDs?

Contract for Differences (CFDs) is an agreement between two parties (your CFD broker and you) to exchange at the close of a contract, the difference between the opening price and the closing price of the underlying stock.

CFDs allow you to buy or sell a large quantity of stock (or index) by putting up a small sum of investment. You can find out more about CFDs by going to www.cityindexasia.com.

So, why would the CFD broker allow you to control US$100,000 worth of Index with just US$750? Well, you have to pay financing charges for the right to 'control' the large value of stock. The financing charges you have to pay are 2% above the London Inter-Bank Offer Rate (LIBOR). The last I checked, the LIBOR was 5.3% which means that the financing charge you pay is 7.3% (5.3%+2%) a year. At first, the thought of paying financing charges of 7.3% per year may seem ridiculous (given that the S&P only returns 10%–12.08%), but if you sit down and do the sums, it becomes worthwhile!

How CFDs can Earn You a Return of 36% on the Index

Let's see how buying Index CFDs compare to buying the Indexes directly (i.e. through the Index ETFs).

Imagine if you had US$1,000 to invest.

If you just bought the S&P 500 Index ETF (i.e. SPDR), you would get an annual return of 10% on average (without dividends reinvested).

If you bought the S&P 500 CFD, a US$1,000 capital would allow you to buy US$13,333.33 of the S&P 500 Index (i.e. US$1,000÷7.5%=US$13,333,33).

Remember that by buying the CFDs, you pay a financing charge of 7.3% a year. So, your actual return would be 10%–7.3%=2.7% a year. Although a 2.7% return may seem really miserable, bear in mind that it is 2.7% of a huge amount of stock (i.e. 13.3333 times of your initial investment)

In one year, your actual profit would be 2.7% x US$13,333.33= US$360.

Since your initial investment was US$1,000, your rate of return would be US$360÷US$1,000=36%! This is precisely how CFDs can allow you to control a large quantity of Index and triple your rate of return.

What is the Minimum Order Size?

The minimum order size for the S&P 500 CFD is 50 shares. So, if the S&P 500 Index is trading at 1400 points, you need to buy a minimum quantity of US$70,000 (50 shares x US$1,400). Your minimum initial investment would be 7.5% x US$70,000=US$5,250 per contract. As the minimal investment is relatively big, I only recommend this strategy for more experienced investors with larger investment accounts.

While CFDs can Triple Your Returns, they can also Triple Your Losses

Do be cautioned that while buying CFDs can magnify your returns, they can also magnify your losses should the market go in the opposite direction! Remember that the minimum order size is 50 shares or US$70,000. Although you only need to put up the capital of 7.5% (US$5,250), it is the US$70,000 that is at risk. If the market were to drop by 10%, your loss would be US$7,000 (excluding the financing charge you have to pay)! In order words, you stand to lose more than your initial investment of US$5,250.

When investing in Index CFDs, do not even think of holding on to the market through ups and downs. Although the market will always bounce back eventually, you will probably not be able to stomach the massive losses if the market plunges in the short term.

Using Index CFDs should therefore NOT be used as a long-term buy and hold strategy! It should only be used for short-term periods (i.e. 3 to 6 months) when the market is in an uptrend. Once the market reverses downwards, you have to take your winnings and run!

Strategy 2: Always Follow The Trend

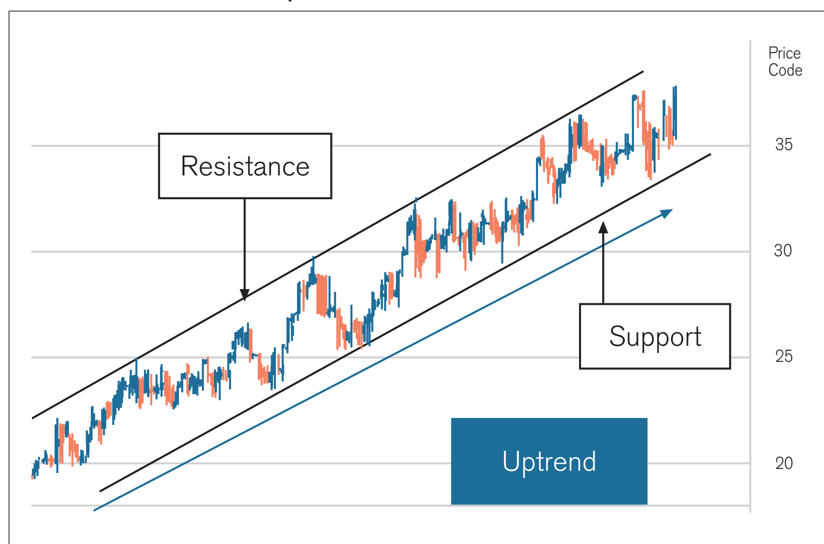
Because of the large amount of money you are dealing with, Index CFDs should only be used when you have a very high level of confidence that the market will only move in a particular direction in the next 3-6 months.

So, how can you be confident that the market will continue to move up in the near future? While there are no guarantees, reading and riding price trends can be a pretty reliable tool.

Remember that stock prices always move in trends. Stock prices can either move in an uptrend, a downtrend or move sideways (known as a consolidation pattern). When the market is in a trend, it has a tendency to keep moving in that particular direction until a reversal of market psychology occurs.

Recall that in an uptrend, market sentiment is positive and though prices may pull back once in a while, buyers' optimism keeps pushing prices higher and higher. As you look at a typical uptrend below, you can see that prices still move up and down. However, each successive low price is higher than the previous low and each successive high price is higher than the previous high. Also notice that the stock price moves up and down within a channel of two imaginary lines known as the 'Support Line' and the 'Resistance Line'.

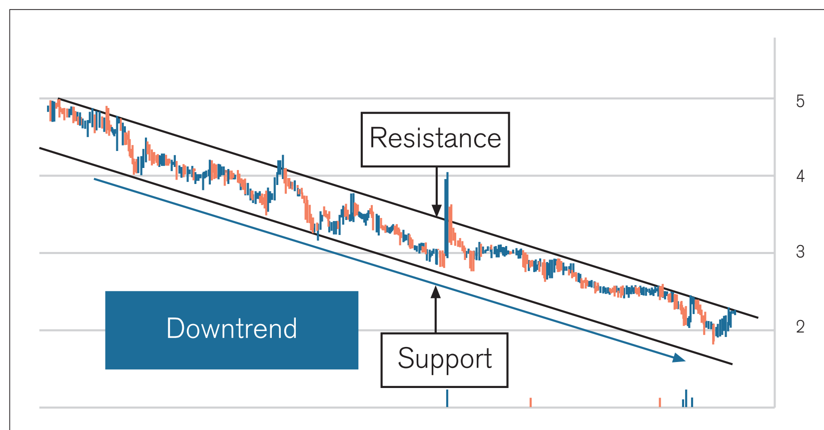
Chart 9: Stock Price On An Uptrend



As the stock price moves up it will tend to hit the 'Resistance Line' and move back down again. Similarly, when the stock price moves down, it will tend to bounce of the 'Support Line' and move back up again!

Similarly, in a downtrend, investors are generally pessimistic and though prices may move up for a while, the general direction of prices tends to be downwards. As you can see below, stock prices in a downtrend also move up and down between a channel created by a 'Support Line' and a 'Resistance Line'.

Chart 10: Stock Price On Downtrend



Now that we know that stock prices move in trends and move within a support and resistance line, how can we use this information to make huge returns on the Index? Well, first you must be familiar with the different trends of the market (i.e. the S&P 500 Index).

By studying the S&P 500 Index over various periods of time, you can see that the market also moves in trends. Take a look at the 10-year chart for the S&P 500 Index below. In the last 10 years, we have experienced three major trends. From 1997-2000, there was an uptrend. Then from 2000-2003, there was a downtrend. Finally, we started a new uptrend in 2003 and are still in the uptrend up to 2006! I call this the S&P 500 4-year trend, since we have been in the trend for 4-years.

Chart 11: S&P 500 Index 10 Years, 1997-2006

Screen capture of www.optionsxpress.com

Does this mean that we should jump in today (i.e. December 2006) and buy the S&P 500 CFDs and continue to ride this trend? The answer is NO! Let's take a closer look at the 4-year trend in the next chart.

Chart 12: S&P 500 Index 3 Years, 2004-2006

Screen capture of www.optionsxpress.com

You can see from the chart above that within a longer-term trend (i.e. 4 year trend), there are many shorter-term uptrends and downtrends that last a couple of months.

Although we are still on a 4-year uptrend, you can see that we are at the very top of the 'Resistance Line'. This means that there is a very strong possibility that the S&P 500 Index will eventually go into another short-term downtrend & move back down to hit the support line in the next couple of months. When this happens, the S&P 500 could potentially lose 80-120 points, which represent US$4,000-US$6,000 per CFD contract. This is why is will not be a good idea to buy the S&P 500 Index at this time!

Ride the Short-Term Trends For Quick Profits

When is the best time to enter into a CFD index contract? I find that the safest and most profitable strategy is to buy ONLY WHEN the S&P index is near the support line and HAS REVERSED into a short-term uptrend towards the resistance line! Always buy only when the new short-term uptrend has been confirmed and NEVER EVER predict a reversal from downtrend to uptrend! Once you have bought, take the ride with the trend all the way to the top and make the profits!

Chart 13: S&P 500 Index 3 Years, 2004-2006 (repeated)

If you had bought the S&P 500 in mid July 2006 once the new uptrend was confirmed, you would have paid US$1,275 per share. Currently (Dec 2006), the S&P 500 is already at US$1414, giving you a profit of US$6,950 per CFD contract! That is a 145% return on your investment in less than 6 months! Doesn't that make the 7.5% financing charge seem negligible?

In addition to reading the Index price's trends and support/resistance lines, it will also be prudent to use 'Technical Indicators' to confirm the strength of the trend before entering into the investment. Technical Indicators are tools that help you to make a decision on when to buy and sell and they are discussed in detail in chapter five.

Sell Once the S&P 500 Reverses into a Confirmed Downtrend

So, the next million dollar question is… when do I sell and take my profits? First let me say that it is almost impossible to predict WHEN and at WHAT price the S&P 500 will reach before it reverses into another downtrend.

So, the smartest approach would be to be extra vigilant and start selling some shares once the price is near the resistance line. The moment the S&P 500 reverses into a confirmed downtrend, take your money and run!

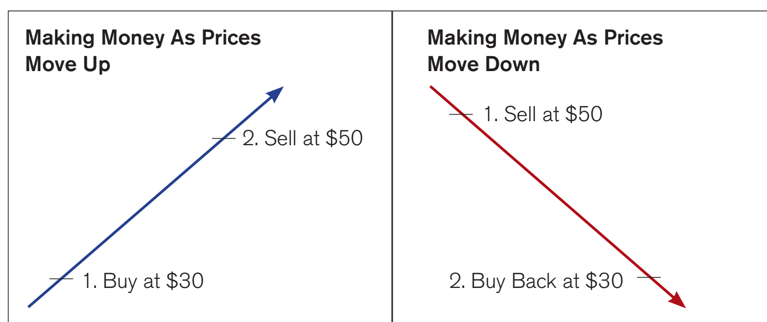
How I Make a Ton of Money When the Market Reverses into a Downtrend

Finally, let me reveal to you my favourite strategy. I am able to make profits from the S&P 500 Index CFD even when the market goes into a downtrend. How? By short-selling the S&P Index at a high price (near the resistance line) and buying it back once the price has fallen to the support line.

For all of you out there who are not familiar with the 'short selling', it means selling stock that you do not own and buying it back later. This is possible because your broker lends you the shares to sell first. You then have to buy back the shares from the market and return it to the broker who lent it to you! Traditionally, investors make money by buying a stock at a LOW PRICE and selling it at a HIGH PRICE (Buy Low, Sell High).

In short-selling, you sell the stock first at a HIGH PRICE and then buy it back again at a LOW PRICE (Sell High & Buy Low). You only employ a short-sell approach when a stock is in a confirmed downtrend. For example, if a stock's price is now $50 and you expect it to move lower as it is in a downtrend. So you short-sell the shares at

$50 and when the stock moves down to $30, you buy it back. So, by selling at $50 and buying back at $30, you make a $20 profit!



Not only do CFDs allow you to short-sell the S&P 500 index, but the best part is, the broker will PAY YOU financing charges and there is no time limit for you to buy back the shares! One of the major CFD brokers in Singapore & London (www.cityindexasia.com) pays you financing charges of LIBOR less 2%. That works out to be about 3.3% per year.

In mid April 2006, I short-sold the S&P 500 Index at 1285 points once it started to go into confirmed downtrend (see chart 14). In three months (July 2006), the Index reached its support line and started to reverse upwards. This was my signal to buy back at 1260 points! By selling at US$1,285 and buying back at US$1,260, I made a total profit of US$1,250 per contract of 50 shares ((US$1,285-US$1,260) x 50 shares)! With my initial investment of US$4,818 per contract, my rate of return was 25.94% in just three months, not counting the financing charges the broker paid me!

Chart 14: S&P 500 Index 3 Years, 2004-2006

Screen capture of www.optionsxpress.com

So as you can see, I can make money in both directions with CFDs! When the S&P nears the support line and reverses into an uptrend, I buy lots of CFD Index contracts and make money on the way up. When the S&P nears the resistance line, and reverses into a confirmed downtrend, I not only sell my CFD contracts to take profits, I also short sell even more CFD contracts and make money on the way down. By continually buying and selling through the ups and downs of the market, I am able to make 50%–100% returns within a year!

4

Value Investing: Warren Buffett's Secret Recipe for Wealth

SECRET
RECIPE

Value Investing: Warren Buffett's Secret Recipe for Wealth

chapter 4

Now that you have learnt the most basic strategy of buying the market, it is time for you to learn how to achieve much higher returns by picking individuals stocks that will outperform the market!

In this chapter, I am going to teach you the very first investing strategy that I learnt. It is called 'Value Investing' and it is with this strategy that I made my first million and a half. Value Investing is the strategy employed by the world's greatest investor and also the second richest man in the world, Warren Buffett. I was first inspired by Buffett's ability to make money in the markets when I read a book that was written about him in 1993. I was so amazed by this man not just because he was worth US$52 billion (just US$4 billion behind Bill Gates), but because he made all his money without selling a single product or service. He made his fortune purely through investing in stocks.

Over a number of years, I read almost every single book written about him as well as his annual report to his shareholders, where he reveals his secrets and strategies for finding stocks that will consistently beat the market over time. It was through modeling Buffett's mindset and strategies that I developed my own strategy for 'Value Investing'. I have found that with Value Investing, you can expect to achieve compounded annual returns of 15%–25%. At this rate, your money would be doubling every three to four years.

Although studying Buffett's methods gave me my initial inspiration, you will discover that the value investing strategies that I am going to reveal to you here go way beyond Buffett's original investment criteria. By adding in additional insights and techniques that I learnt from other experts, I have found that I can in fact make higher returns

within an even shorter period of time! Before we go any further, it is very important for you to understand the history and psychology of the world's greatest value investor…

The History & Psychology of Warren Buffett

From a very early age young, Warren Buffett was obsessed with making money and had a very clear dream of becoming the world's greatest investor. Born during the depression when his father was close to bankruptcy, Warren learnt about the value of money and the importance of being financially secured at an early age.

Even before his teens, Warren knew that he wanted to be rich, very very rich. As early as elementary school and later on in high school, he would tell his classmates that he wanted to become a millionaire before the age of 35 (when he turned 35, his net worth exceeded US$6 million). Inspired by his dream, he started researching on the secrets of wealth creation.

Through his readings, he found and memorized a book called 'A Thousand Ways to Make $1,000'. At the age of six, he started buying coke bottles at 25-cents per six-pack and selling them at 5-cents a bottle, giving him a 16% gross profit, as he would tell himself. At the age of 13, he got a job delivering newspapers and through innovative marketing and distribution strategies, he served five hundred customers a day (he hired the other neighbourhood kids to do the delivery for him).

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'. While most kids his age were reading comic books, Warren spent his time reading company annual reports. By the age of 14, he invested in pinball machines, which he installed in restaurants all over his town. He was earning US$175 a week, as much as the average 25-year old was earning in 1944.

Warren later mastered the art of investing by modeling two of the world's greatest investors during his time, Benjamin Graham (the father of Value Investing) and Philip Fisher (the father of Growth Investing). By combining the ideas of both geniuses and further refining them, Buffett has become the most powerful investor in the world!

Lesson One: Invest from a Business Perspective

One of the most important lessons he learnt was to invest from a business perspective. Most people treat stocks like lottery tickets. Buying and selling based on predictions of whether the price will go up or down in the short term. Based on world events stock prices go up and down randomly and erratically, hence there is no way anyone can consistently beat the market by attempting to predict its movements. Many of these punters know every little about the business operations behind the stocks they own.

Warren learnt that buying a stock meant becoming a part-owner of an ongoing business. He knew that the only way to consistently make money was to identify very good businesses run by a strong management team. Good businesses would over time generate higher and higher profits. Increasing profits will increase the value of a company and hence its share price. By honing his expertise in sniffing out companies that had the potential to generate huge amounts of earnings growth over time, he was confident that the stocks he held onto would increase significantly in price over time.

Lesson Two: The Market is Irrational, Take Advantage of It

While most financial experts teach that the market is rational and efficient (stock prices reflect the true value of a company), Benjamin Graham taught Buffett that stock market prices were determined by demand & supply, which in turn are irrationally driven by fear and greed. As a result, a stock's price did not always reflect the true value of a company.

In times of mass investor optimism & greed, buyers rush in and push a stock's price way above its value. In times of fear and panic (i.e. news of a recession) investors sell their shares, causing a stock's price to fall way below its value.

The Market tends to overvalue a company's stock when there is good news and under-value a company's stock when there is bad news.

Benjamin Graham developed a systematic way to determine a stock's true value (known as its intrinsic value) and taught that by buying a stock when it was undervalued, the investor could make a huge profit when the market eventually overvalued the stock. Philip Fisher added another dimension to investing by developing a way to not only find undervalued companies, but to find companies that had the potential to also significantly grow in their earnings and hence increase their stock value even higher. You are going to learn exactly how to do it in this chapter! How powerful can this strategy be? Well let's look at Buffett's track record.

Buffett's Phenomenal Record: Doubling his Money Every Three Years.

Over the last 49 years, Warren Buffett managed to achieve a 24.7% annual compounding rate of return, which means he doubled his money every 2.9 years for half a century! He turned an initial investment of $100,000 into a staggering $42 billion. How was he able to consistently beat the market (only 10% of professional fund managers are able to beat the S&P 500 Index every year) and all the smartest money managers on Wall Street?

Well, it was because his beliefs, philosophies and investing strategies went totally contrary to the average money manager or individual investor. This is why Buffett is known as a 'Selective Contrarian Value Investor'. When most people started selling a stock, he would jump in and buy as much as he could (if he knew it was actually a good company that was under-priced) and when everyone starting buying a stock and pushing the price up, he would sell for a huge profit.

During the Dot Com euphoria that drove the stock market to new highs in 1999-2000, just about every investor was buying into technology stocks and ignoring old-economy stocks. Everyone… that is, except Warren Buffett.

He did the complete opposite by selling all the stocks he owned and held on to cash, sensing that the biggest crash in history was going to come. By understanding the true worth of the technology companies, he knew that their stock prices were insanely overvalued. However, everyone started criticizing the old man for losing his touch and missing out on a great bull run.

Sure enough, the market plunged by over 40% over the next year and turned former stock market millionaires into bankrupts. All the funds on Wall Street lost millions of dollars, except Warren Buffett's company Berkshire Hathaway. Once the market hit rock bottom and everyone avoided buying anything, Buffett took all his cash and picked up some of the most valuable companies for half their price, now that panic had caused companies to become undervalued as he expected. Within the next three years, he sat on billions of dollars in profit. Today, his company Berkshire Hathaway is the most expensive company in the world, with a share price of $100,000 per share! Let's begin learning the secrets of this legendary investor.

Warren Buffett Versus Wall Street

Before you can successfully model a person's investment strategy, you must first model their beliefs. It is a person's beliefs about investing that shape their decisions, their actions and their results. The reason why Warren Buffett is able to consistently beat the market of average investors & money managers is because he holds very different beliefs and philosophies about how the markets work. Let's compare the beliefs of Warren Buffett to the beliefs of the average investor or fund manager.

Wall Street	Warrent Buffett
Believes in broad diversification into numerous financial instruments.	Believes in concentrating his funds in a few core businesses that he understands very well.
Short-term performance focused. Buys when a stock's price is rising (good news) & sells when a stock is falling (bad news).	Long-term value focused. Buys good stocks when the price is falling (bad news) & sells when the price is rising (good news).
Prejudice against companies who don't pay dividends.	Prefers company to retain its earnings & allow his wealth to compound tax-free
Pressured to invest funds	Invest only when there is a high probability of profits.
Believes that in order to achieve higher returns, you must take higher risks	Believes it is possible to achieve high returns with very low risks.

Broad Diversification Versus Focus

Fund managers and financial experts often advise clients to broadly diversify their money across many different financial instruments such as stocks, bonds, currencies & money market funds. The logic is that by spreading your money into different areas, you reduce your risk.

Master Investors like Warren Buffett believe that although broad diversification reduces risk, it also reduces any potential of return. If you invest in 50 stocks, then for your portfolio to double in value, you must find 50 stocks that double in value. That is almost impossible! At the same time, by investing in so many companies and instruments, it is impossible for you to become an expert in anything. He believes that people diversify into everything to protect themselves against their own ignorance! It's like asking the great tenor Luciano Pavarotti to diversify into 'Heavy Metal', 'Country & Western', Techno, Hip Hop and 'R&B' in order to reduce his risks in case he does not do well in Opera.

Instead, Warren Buffett believes in focusing all his money into a few, very well selected stocks that he knows will double in value. He believes that an investor must only invest into a few companies that he understands very well and can track very closely. He calls it investing within your 'circle of competence'. Does this mean that you should bet your entire savings on one or two companies? Of course not! That is too dangerous. It is still important to spread your money across at least 8–10 stocks that you know inside out. However, once you buy more than that, it becomes harder to invest intelligently.

Following the Market Versus Going Against the Market

Fund managers & the investing public tend to be very short-term performance focused. They tend to buy a stock when there is lots of good news (i.e. economy is strong, company's earnings beats forecast, launch of a new product etc…) that pushes the stock price higher and higher. Consequently, they tend to jump out of a stock when bad news sends the stock price falling. Actually, there is nothing really wrong with this approach.

By doing so, you are investing along with the trend. This strategy is known as 'momentum investing' and we are going to be looking at it in the next chapter. However, the danger with 'momentum investing' is that it is all about timing and the ability to read into investor psychology.

The trouble is that most average investors who lack these skills jump in too late (after all the professional funds have entered), when the stock price has already risen near its peak! Sure enough, they find that the stock prices start falling the day after. Out of fear and panic, they sell the stock and end up with a loss. This is why the typical investor always experiences their stock price falling soon after they have entered the market.

On the other hand, value investors like Warren Buffett take a Contrarian approach. They go against the market psychology and trend. They buy the stock of a good company when nobody else wants it. This is when the stock price is extremely low and attractive. They then wait patiently for the stock to come into favour again. When optimism returns and the crowd starts to push the shares of the company higher and higher, the value investor will then sell his shares at a nice profit.

High Risk, High Return Versus Low Risk, Low Return

While many financial experts preach the concept of having to take high risks in order to make high returns, master investors like Warren Buffett believe that it does not take high risks to make high returns. Instead, it takes a high level of financial and business competence to make high returns!

In fact, he will only make an investment when there is a very low risk of loss and a very high probability of gain. He does this by only investing in companies that are selling way below their true value. In this way, he gives himself a wide margin of error. Which means even if his calculations are off, he will still be making money.

Invest Only when there Is a High Probability of Success

The trouble with professional managers of mutual funds is that they are pressured to invest 80% of their cash into the market, even when there is nothing attractive to buy. This happens after a prolonged bull-run when stock prices are so high that companies are way overvalued.

On the other hand, Buffett would happily keep all his money in cash and only invest when there is a golden opportunity. This is exactly what happened in 1999-2000 (stock prices were insanely overvalued) when Buffett was criticized for not making a single investment and keeping all his money in cash.

Buffett only moved in to buy after 2001, when stock prices had crashed and companies could be bought for a steal. So, if you want to be able to consistently beat the market and make higher returns than anyone else, shouldn't you begin by adopting the beliefs of the world's greatest investor?

The Strategy of the Value Investor

Now that you know the beliefs that drive value investors like Warren Buffett, let's find out the specific strategies they use to make sizable returns in individual stocks. There are three major steps that Value Investors take and they are: 1. identify great businesses, 2. buy them only at a huge discount and 3. wait for the market to realize their true value or overvalue them.

Step 1: Identify Great Businesses

Always remember that when you are buying a stock, you are not buying a lottery ticket. You are buying part-ownership of a company. If you want the value of your stock to increase over time, you must identify and invest in great businesses. And you must truly understand the business behind the stock.

So, what is a great business? It is one where we can predict with confidence that, over the long-term, the company's earnings (profits) and hence stock value will increase (if a company can make increasingly higher profits in the future, it would become more valuable). When the value of the company increases, the stock price will eventually increase.

While bad news and disasters like wars, recessions and new competition will always cause the market to panic and stock prices to plunge, a very good business is one that we are confident will always recover and prosper after such events.

In the next part of this chapter, you will learn specifically how to select companies that are financially strong and have a high certainty for growth. In this case, you do not have to depend on market predictions for your stock's price to rise, but you are certain it will rise because of its strong business fundamentals and earnings.

Step 2: Buy them Only At A Huge Discount

Great companies with strong earnings, financial strength and high growth potential are usually expensive to buy (their stock price is often overvalued) as they are usually the favorite of fund managers and stock analysts.

However, the market always goes through booms and busts and there will always be short-term bad news that hits a company, no matter how great it is (e.g. the company reports lower than expected profits, new product failure, recession fears). It is under these circumstances that the irrational short-term orientated market will panic and sell the stock until its price is way below its intrinsic value.

The smart value investor who knows the true value of the stock, will buy as much as he can at such times, thereby getting a huge 'discount'. He knows that the market will eventually come to its senses and recover, correcting the stock price and bringing it up to its true value. This is when very substantial returns are made for the investor who is patient and confident in his purchase.

Step 3: Wait For The Market to Realize a Stock's True Value Or Overvalue It.

The best time to sell is when the stock market is booming or there is good news that makes the market over-react. Investors will flock to buy up so much stock that the prices of all stocks rise above their intrinsic value. When a stock is highly overvalued, it is a good time to sell as you will make a huge profit.

Important: Once again, it is very important to remember that you should only buy a stock when the bad news that hits the company is only temporary and will not affect its long-term growth and profitability. If the bad news results in causing permanent damage to the company's profits, (e.g. costs of raw materials spiral up, profit margins drop because of intense competition) then it is a poor investment and the stock's value will probably never recover.

How Warren Buffett made Billions by Buying & Selling Undervalued Companies

This strategy is exactly how Warren made millions of dollars in profits consistently every year for the past 50 years. One of his first major investments was in American Express (AXP) back in the 1960s. At that time, American Express was being sued for negligently verifying a collateral that did not exist. The company was ordered to pay $60 million in damages and that almost wiped out its entire shareholder's equity. The market panicked and sent Amex's stock price crashing from $60 in November 1963 down to $35 in early 1964! However, Warren knew that though the company lost more than 90% of its value from the lawsuit, it could, over time, easily make back all its losses and a lot more.

This is because American Express was the number one credit card company in the United States. Its monopoly of the credit card market was not affected at all and its travelers checks business remained intact. Knowing that the loss was only temporary and that Amex could easily make everything back and more, Warren invested 40% of his capital and purchased a huge amount of Amex stock (4% of the total outstanding stock). Two years later, he sold for a $20 million profit.

Another example is when toy maker Mattel acquired The Learning Company in 1999. It turned out to be a bad move as The Learning Company made huge losses and Mattel lost $200 million as a result. The market panicked and sold down Mattel shares from $46 in 1998 to $9 in 2000! Once again, Warren knew that the market had overreacted and that the loss was temporary. By selling its loss making subsidiary and focusing on its winning toy brands like Barbie, Mattel could easily make back everything and a lot more! Sure enough, in 2001 the price eventually recovered to $18, making Warren a 100% profit in one year.

How I made a 35% Profit Buying AIG Stock

Let me give you a recent example of how I have profited from this strategy. In mid February 2005, AIG announced that it was being investigated for accounting irregularities that artificially inflated its value by US$1 billion to US$3 billion. Fear that the stock may be worth a lot less than what was reported sent the market into a panic and millions of AIG shares were sold, sending the stock price from $74 to $50 (a 32% drop). I saw this piece of bad news as a tremendous opportunity as I believed that the market had overreacted and the stock price was now way below its intrinsic value. AIG is a great company and the bad news was only a temporary setback.

Here are four reasons:

1. Although a $3 billion overstatement may seem big, AIG's net worth of $79 billion means that the company's value may only be overstated by about 4% ($3 billion ÷ $79 billion). So a 25% drop in stock price is a major over-reaction.

2. AIG's long term earnings and growth will probably not be affected at all as AIG is only a holding company and its portfolio of insurance companies are not implicated at all. The firm's foreign life insurance (e.g. AIA), aircraft leasing and asset management products should deliver profits as per normal.

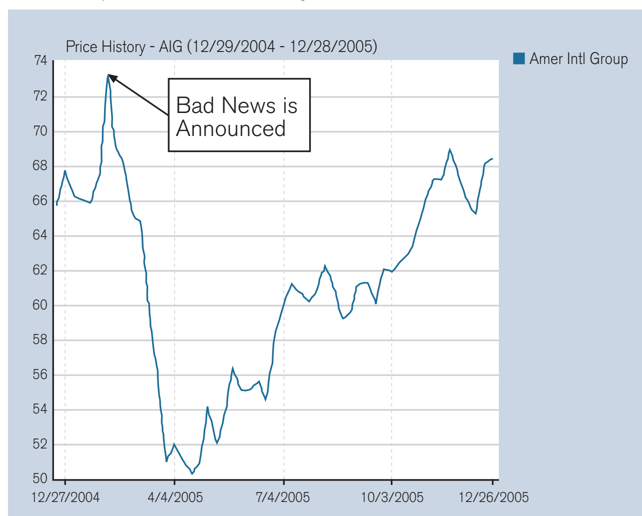
3. AIG's companies' have strong competitive advantages (huge distribution network) that will continue to lead to high earnings growth and stock value increase.

4. The CEO who is believed to be responsible for the irregularities had resigned and external auditors had been appointed to clean up the company's accounts for the past five years.

As a result, I invested a sizable amount of money into buying AIG stock at an average price of $51, knowing that its intrinsic value was really about $80. Sure enough, within nine months, the market regained its sanity and pushed the stock price to $69, giving me a 35% return! At the time of me writing this book, AIG stock is already passed $71!

Table 1: Price History of American International Group (AIG)

Screen capture from www.moneycentral.com



"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

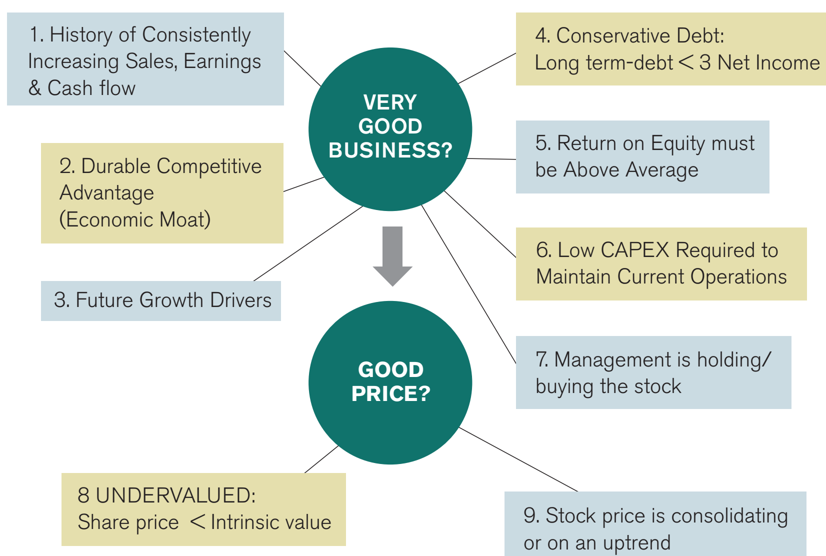
The 9 Criteria of Buying a Great Company at a Huge Discount

So, how do you go about finding great businesses that are selling at a good price? Well, there are altogether 9 criteria to help you screen for these hidden gems.

Do bear in mind that in order to distinguish a great company from a lousy one, you must learn some basic accounting and financial concepts, which is the language of business. You must learn how to read a company's 'Income Statement', 'Balance Sheet' and 'Statement of Cash Flows'. These three report cards tell you everything you need to know about how financially strong a company is and how good it is at making money. If you have little or no basic knowledge on this, I highly suggest you to read my earlier book 'Secrets of Self-Made Millionaires' where I teach the basics of accounting concepts.

Let's begin by looking at an overview of the 9 criteria. If you had read my earlier book 'Secrets of Self-Made Millionaires', you would also have realized that I added an additional criteria to help you better time your entry into the investment.

Overview of the Nine Criteria for Value Investing



The first 7 criteria are used to determine if the stock you are investing in is a great business that will grow in value over time. The 8th and 9th criteria are used to determine if the price is right and if it is the best time to buy the stock. Let's look at each of these criteria carefully by using Wal-Mart Stores, Inc (WMT) as our case study.

Wal-Mart Stores, Inc (Ticker symbol: WMT), is the largest retailer in the world, with nearly 7,000 stores around the globe. It operates Wal-Mart discount stores, Neighborhood Markets and Wal-Mart Supercenters. Wal-Mart employs over 1,700,000 people worldwide (almost half the population of Singapore).

Interesting Trivia: Among the top ten richest people in the world, three of them attained their wealth through possessing shares in Wal-Mart. They inherited it from the late founder Sam Walton. If Sam Walton were alive today, he would be richer than Bill Gates.

Criteria #1: History of Consistently Increasing Sales, Earnings and Cash Flow

** Note that earnings, net income and profits are used interchangeably, while Sales & Revenue are used identically*

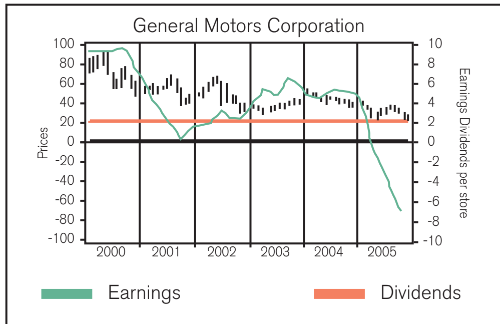
A company's value and stock price is basically determined by how much profits it makes and how much profit it is expected to make in the future. The higher a company's earnings and future earnings growth, the more valuable its stock!

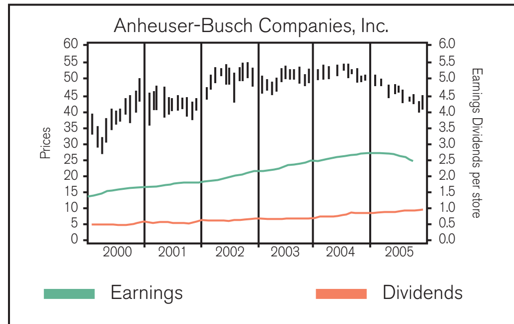
The first way to determine if a company will be able to consistently increase its earnings is to look at its track record. If the company shows a history of consistently increasing sales and earnings over the last five years at least, especially during periods of recession, then there is a high chance it will be able to continue its performance.

If a company's past earnings show consistency, then future earnings will be more predictable to forecast with confidence. For example, look at General Motors Corp and Anheuser-Busch company's earnings (in green) and price chart (in black). General Motor's past earnings are too erratic to predict with certainty. However, Anheuser-Busch Company's earnings can be forecasted with a lot more confidence.

Chart 2: Stock Price & Earnings Chart

Screen capture from www.corporateinformation.com





Besides ensuring that earnings have been increasing consistently, it is also important to verify that sales have also been increasing. This is because earnings can be creatively manipulated by accountants (this unfortunately is very common), but sales cannot be changed. If a company shows earnings increasing with a corresponding stagnation or drop in sales, it sometimes means that the company is not really doing better but doctoring its books.

Finally, it is only important to ensure that the company's operating cash flow has also been increasing consistently. Operating cash flow is the actual amount of cash that comes into a company as a result of its business operations. Sometimes, a company can have increasing sales and profits, but with declining cash flow. This could be due to the company being inefficient at collecting money that is owed to them. A profitable company that runs out of cash flow will also soon die.

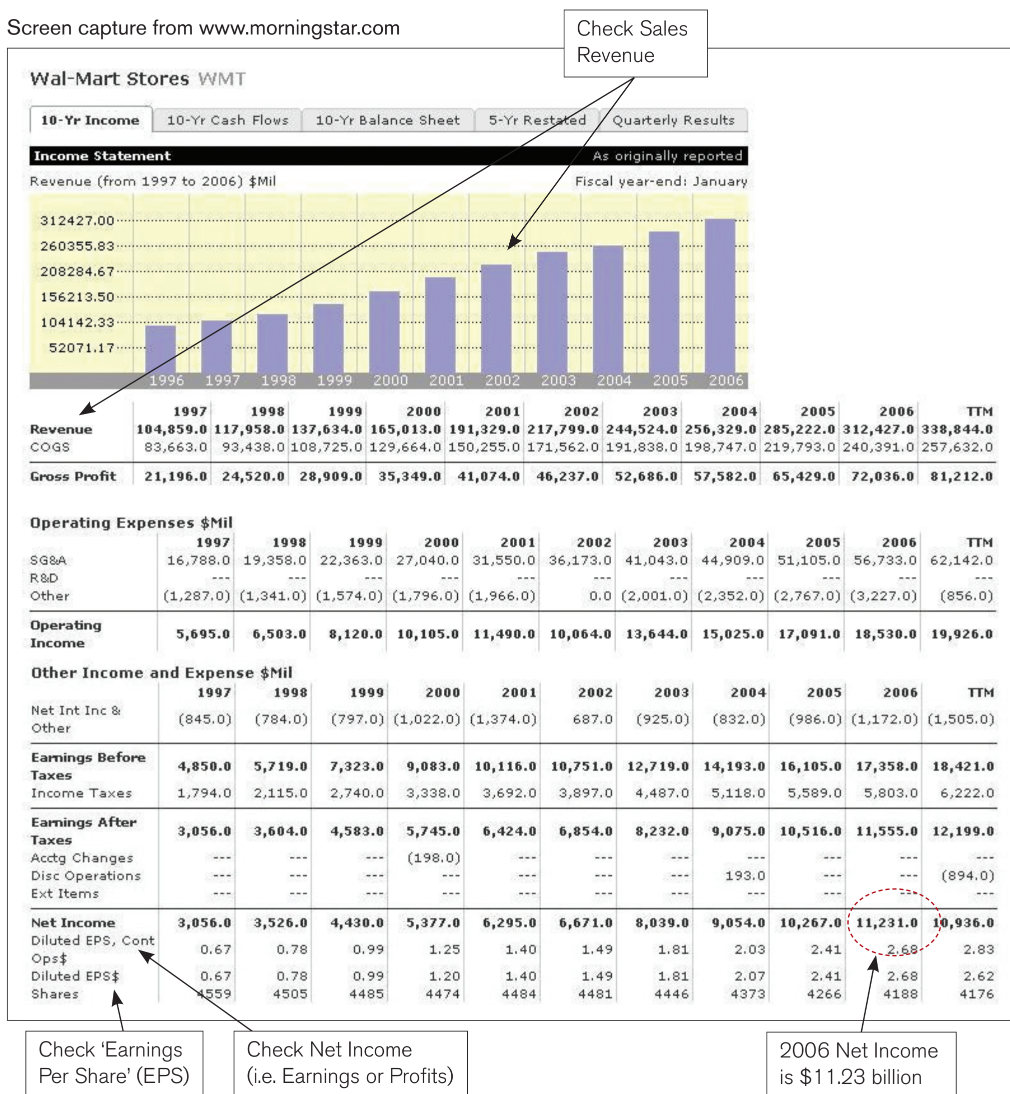
Where Do I Find This Information?

Sales, earnings & cash flow can be easily found by running through the annual reports of the companies you are researching on. Just go to the section under 'Income Statement' (also known as Profit & Loss Statement) to check sales and earnings information and go to the section under 'Statement of Cash Flows' to look at the company's operating cash flow (also known as net cash from operations).

Currently, you can read a company's entire history of annual reports for free on the Internet at websites such as www.annualreportservice.com (for US companies) or www.sgx.com (Singapore companies). Alternatively, just go to financial research websites like www.moneycentral.com, http://finance.google.com or www.morningstar.com where you can read a company's entire history of financial statements for free.

Table 3: Income Statement from Morningstar.com

Screen capture from www.morningstar.com



Wal-Mart Stores WMT

10-Yr Income | 10-Yr Cash Flows | 10-Yr Balance Sheet | 5-Yr Restated | Quarterly Results

Income Statement — As originally reported

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Revenue	**104,859.0**	**117,958.0**	**137,634.0**	**165,013.0**	**191,329.0**	**217,799.0**	**244,524.0**	**256,329.0**	**285,222.0**	**312,427.0**	**338,844.0**
COGS	83,663.0	93,438.0	108,725.0	129,664.0	150,255.0	171,562.0	191,838.0	198,747.0	219,793.0	240,391.0	257,632.0
Gross Profit	**21,196.0**	**24,520.0**	**28,909.0**	**35,349.0**	**41,074.0**	**46,237.0**	**52,686.0**	**57,582.0**	**65,429.0**	**72,036.0**	**81,212.0**

Operating Expenses $Mil

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
SG&A	16,788.0	19,358.0	22,363.0	27,040.0	31,550.0	36,173.0	41,043.0	44,909.0	51,105.0	56,733.0	62,142.0
R&D	---	---	---	---	---	---	---	---	---	---	---
Other	(1,287.0)	(1,341.0)	(1,574.0)	(1,796.0)	(1,966.0)	0.0	(2,001.0)	(2,352.0)	(2,767.0)	(3,227.0)	(856.0)
Operating Income	**5,695.0**	**6,503.0**	**8,120.0**	**10,105.0**	**11,490.0**	**10,064.0**	**13,644.0**	**15,025.0**	**17,091.0**	**18,530.0**	**19,926.0**

Other Income and Expense $Mil

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Net Int Inc & Other	(845.0)	(784.0)	(797.0)	(1,022.0)	(1,374.0)	687.0	(925.0)	(832.0)	(986.0)	(1,172.0)	(1,505.0)
Earnings Before Taxes	**4,850.0**	**5,719.0**	**7,323.0**	**9,083.0**	**10,116.0**	**10,751.0**	**12,719.0**	**14,193.0**	**16,105.0**	**17,358.0**	**18,421.0**
Income Taxes	1,794.0	2,115.0	2,740.0	3,338.0	3,692.0	3,897.0	4,487.0	5,118.0	5,589.0	5,803.0	6,222.0
Earnings After Taxes	**3,056.0**	**3,604.0**	**4,583.0**	**5,745.0**	**6,424.0**	**6,854.0**	**8,232.0**	**9,075.0**	**10,516.0**	**11,555.0**	**12,199.0**
Acctg Changes	---	---	---	(198.0)	---	---	---	---	---	---	---
Disc Operations	---	---	---	---	---	---	---	193.0	---	---	(894.0)
Ext Items	---	---	---	---	---	---	---	---	---	---	---
Net Income	**3,056.0**	**3,526.0**	**4,430.0**	**5,377.0**	**6,295.0**	**6,671.0**	**8,039.0**	**9,054.0**	**10,267.0**	**11,231.0**	**10,936.0**
Diluted EPS, Cont Ops$	0.67	0.78	0.99	1.25	1.40	1.49	1.81	2.03	2.41	2.68	2.83
Diluted EPS$	0.67	0.78	0.99	1.20	1.40	1.49	1.81	2.07	2.41	2.68	2.62
Shares	4559	4505	4485	4474	4484	4481	4446	4373	4266	4188	4176

As you can see from the income statement from Table 3, Wal-Mart Stores has seen consistent sales revenue and net income (i.e. earnings) growth over the last 10 years. Now, let's look at its 'Cash Flow from Operations' from its 'statement of cash flows' in Table 4. Again, you can read that it has consistently increased from $5,930 million to $17,633 million for the last 10 years.

Table 4: Statement of Cash Flows From Morningstar.com

Screen capture from www.morningstar.com

Wal-Mart Stores WMT

10-Yr Income | 10-Yr Cash Flows | 10-Yr Balance Sheet | 5-Yr Restated | Quarterly Results

Cash Flows — As originally reported

Cash Flows From Operating Activities $Mil

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Net Income	3,056.0	3,526.0	4,430.0	5,377.0	6,295.0	6,671.0	8,039.0	9,054.0	10,267.0	11,231.0	10,936.0
Depr & Amort	1,463.0	1,634.0	1,872.0	2,375.0	2,868.0	3,290.0	3,432.0	3,852.0	4,405.0	4,717.0	5,216.0
Deferred Taxes	(180.0)	20.0	(640.0)	(138.0)	342.0	185.0	520.0	177.0	263.0	(129.0)	(129.0)
Other	1,591.0	1,943.0	1,918.0	580.0	99.0	114.0	541.0	2,913.0	109.0	1,814.0	3,561.0
Cash from Operations	**5,930.0**	**7,123.0**	**7,580.0**	**8,194.0**	**9,604.0**	**10,260.0**	**12,532.0**	**15,996.0**	**15,044.0**	**17,633.0**	**19,584.0**

Cash Flows From Investing Activities $Mil

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Cap Ex	(2,643.0)	(2,636.0)	(3,734.0)	(6,183.0)	(8,042.0)	(8,383.0)	(9,355.0)	(10,308.0)	(12,893.0)	(14,563.0)	(15,575.0)
Purchase of Business	0.0	(1,865.0)	(855.0)	---	---	---	---	---	---	(601.0)	(669.0)
Other	575.0	80.0	171.0	(10,663.0)	(672.0)	1,237.0	(354.0)	1,996.0	542.0	981.0	1,445.0
Cash from Investing	**(2,068.0)**	**(4,421.0)**	**(4,418.0)**	**(16,846.0)**	**(8,714.0)**	**(7,146.0)**	**(9,709.0)**	**(8,312.0)**	**(12,351.0)**	**(14,183.0)**	**(14,799.0)**

Criteria #2: Sustainable Competitive Advantage

Although a company may have been able to increase its earnings in the past, there is no guarantee that it can continue to do so in the future. New competitors could enter and steal market share or cause price drops, forcing the company to experience lower sales and earnings.

So, what will prevent this from happening? What can ensure that competitors will not be able to capture customers, even if they lower their prices? The answer is a sustainable competitive advantage.

Let me give you an example. What allows Nike to sell more and more shoes every year, allowing it to consistently increase its earnings? Why can't competitors capture all of Nike's customers by offering a cheaper shoe? Even if you could invent a better shoe called Niko, could you take away all of Nike's customers? Highly unlikely. Why? The answer is because Nike's brand name gives it a competitive advantage.

People buy Nike because of loyalty to the brand and the powerful feelings that the famous Swoosh logo conveys! And sure enough, this competitive advantage it has against other shoe manufacturers will be sustained for many years to come, protecting it from any rivals. This is known as a sustainable competitive advantage. Like a wide moat around a castle, it protects the company's future profits from invaders. This is why companies like Nike are also known to have a wide economic moat.

However, a powerful brand name is not the only thing that gives a company a sustainable competitive advantage. Being a large company with huge economies of scale also provides a business with a wide economic moat. For example, it is very difficult for any competitor to compete with Wal-Mart stores (US largest retailer) or Amazon.com (largest Internet bookstore). Because of their massive size, they are able to buy millions of dollars worth of goods at whopping discounts, thus allowing them to price their items below anybody else.

Being a market leader is also a powerful competitive advantage. For example, VISA is so widely used as the number one credit card that almost all stores must accept it and almost every credit card user has to carry it. It would be almost impossible for anybody to start a new credit card and take away a huge chunk of VISA's business.

As a market leader, EBAY's impenetrable moat comes from the fact that it has 1 million registered users worldwide and has 10 million transactions per day. It is 'the' place to go if you want to find the best prices to buy and sell products on line. No other site with all the advertising or money in the world can ever compete.

Sometimes, a company's sustainable competitive advantage could be in the form of a special formula, technology or a patent they own. Pharmaceutical companies are able to continually make huge profits because they own patents on specific drugs (e.g. Viagra, Panadol etc…) that no other company can legally copy and manufacture.

When you invest in a company that has a strong, sustainable competitive advantage that protects it against competitors and allows it to retain and build its customer base, you can predict with certainty that earnings and stock value will continue to increase.

In general, a company's sustainable competitive advantage can come from:
a. A Strong Brand (e.g. Coke, Nike, PepsiCo, Proctor & Gamble etc…)
b. Patents and trade secrets (e.g. Pharmaceutical companies like Pfizer, Merck)
c. Gigantic Economies of scale. (e.g. Wal-Mart Stores, Amazon.com etc…)
d. Market leadership that competitors will find very difficult to overtake in the next decade. (e.g. General Electric, VISA, EBAY, Google.com)
e. High switching costs that lock in customers (e.g. Adobe, Stryker, Microsoft)

Characteristics of Sustainable Competitive Advantage Businesses (Wide Economic Moat)

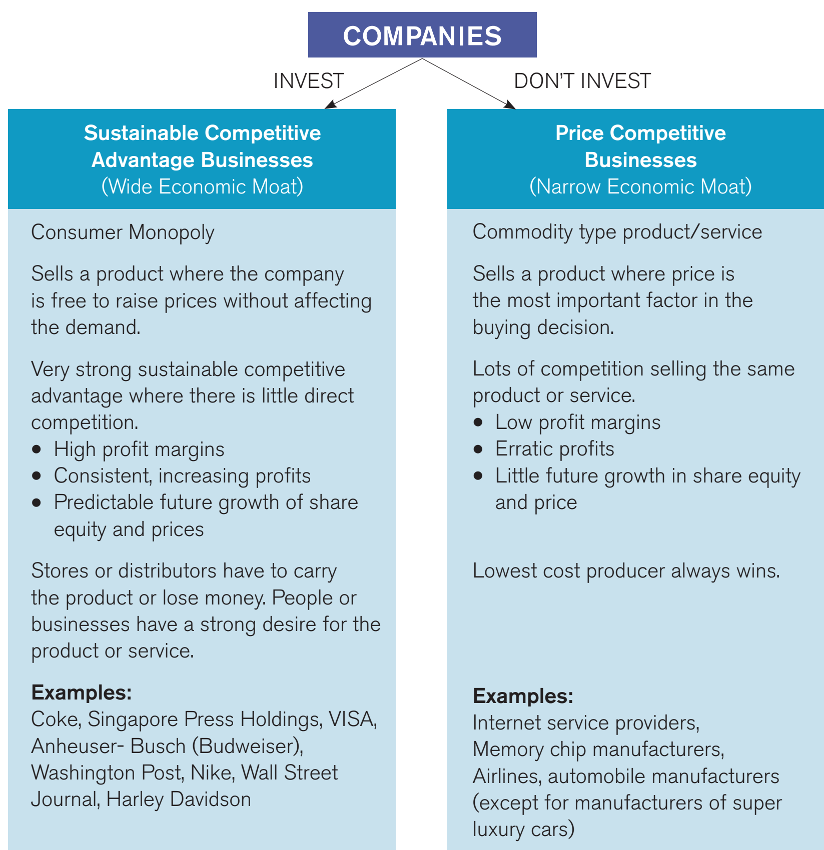
So how do you know if the company you want to invest in has a wide economic moat? These companies usually sell a product or a service that is a consumer monopoly. This means that it is usually so unique and special that even if prices are raised, demand will still be strong. For example, even if Ferrari, Nike, McDonalds, Harley Davidson or Microsoft were to raise prices, people will still buy, as it is perceived as 'nothing else comes close'. Because of low direct competition, these wide moat companies enjoy high profit margins and continually increase profits and stock value. Stores have to carry their products or risk losing customers. For example, a supermarket must carry Coca-Cola and a pharmacy must sell Pampers (by Proctor & Gamble) or they will lose customers.

Characteristics of Price-Competitive Businesses (Narrow Economic Moat)

On the other hand, avoid investing in companies that are price-competitive businesses with no real competitive advantage. These companies usually sell a commodity-type product that thousands of other businesses do. As a result, price is usually the most important factor in the buying decision. If this company were to raise prices by just 5%, they would lose many of their customers to a cheaper

competitor. Petrol companies, manufacturers of raw materials, Internet Service Providers, Airlines, Telecommunications and Automobile manufacturers all fall into this category.

While it can be argued that companies like Mobil, British Airways and Ford are strong brands, ultimately they cannot arbitrarily raise prices and still retain all their customers. I am sure that if Starhub or British Airways were to raise prices by 10%, many of their customers would consider moving to a cheaper alternative. However, if a true consumer monopoly like Ferrari were to raise prices by 20%, many customers would still buy. As a result, price-competitive businesses usually have lower profit margins and erratic profits. Because they mainly compete on price, a lot of their earnings are usually re-invested to improve operational efficiency and not into building new products and creating markets that will further increase sales and profits.



Although Wal-Mart's positioning is that of a 'discount store', its huge economic moat and sustainable competitive advantage comes from its sheer size and retail monopoly in the United States. No other retailer can match its range of products and its ability to buy large volumes of products at low costs. This allows it to offer the best discounts (that no other retailer can match) and at the same time earn supernormal profits.

Criteria #3: Future Growth Drivers

Having a good track record and a strong sustainable competitive advantage will not automatically translate into higher sales and profits in the future unless the company has the market potential with concrete plans which will translate into the sale of substantially more goods and services.

If the company has no plans to create new products or to enter new markets then future sales and profits will not keep growing. You must ensure that the company you want to invest in has some of the following growth drivers:

- Development of new product lines
- Upcoming product innovations
- New application of patents
- Expansion in capacity (e.g. building bigger factories)
- Opening new markets
- Building more outlets
- Huge untapped market potential

To find out more about a company's future growth drivers, you can usually read it in the 'CEO's Message' or 'Letter to Shareholders' in its latest annual report. Alternatively, go to the company's main webpage and you will find it somewhere under 'investor relations'.

For our case study, go to www.walmart.com and download their 2006 annual report. If you read the CEO's message to shareholders and the summarized 'highlights of the year' (Table 5), you will find that Wal-Mart still has enormous growth potential ahead. In the US alone, its Supercenter stores are still highly concentrated in the South, the Midwest, and suburban and rural areas, leaving plenty of room to

expand in the Northeast, California, and some major metropolitan areas. Management also has big plans of achieving double digit sales growth by opening 305 new stores in the US and 220 new stores internationally in 2007.

Table 5: Wal-Mart Highlights of the Year

Extracted from Wal-Mart 2006 Annual Report to shareholders

Highlights of the year			Looking ahead
• Added 267 supercenters, 24 discount stores and 15 Neighborhood Markets; grew sales by over $18 billion, which was an increase of 9.4% • Leveraged expenses in the second half of the year, particularly wages	• Launched new creative marketing for the holiday season with the "Home for the Holidays" theme • Utilized consumer insight – overall emphasis and understanding of consumer segments drove introduction of new merchandise lines such as Metro 7™ apparel	• Reorganized our operations team to focus on improving the customer experience in our stores • Implemented successful Network Remix in Florida, reducing store inventory and enhancing shelf in-stock • Provided exceptional, timely logistical service to customers and hurricane victims	Wal-Mart U.S. expects to open over 305 new, relocated or expanded units in the fiscal year ending January 31, 2007. Our main focuses will be to achieve double-digit sales growth and continue to improve return on investment as we strengthen the customer experience.
• Added 17 new clubs and grew sales by 7.2% over last year to $39.8 billion • Significantly increased the number of PLUS members at our premium level, by offering more services, including up to 2% cash back on our Discover® card for select purchases	• Delivered solid financial performance, growing profits faster than sales and improving return on investment to a four-year high • Introduced an affordable health insurance program available to all members and in all U.S. states	• Expanded our online product offerings, most notably office supplies • Continued to excite members with affordable luxuries, such as handbags by Kate Spade®, premium wines and 61-inch plasma televisions	SAM'S CLUB plans to open over 30 new, relocated or expanded clubs in the fiscal year ending January 31, 2007. Our ongoing commitment to small business owners and increased attention to the personal needs of our Advantage Members will help us accelerate sales growth. We continue to build quality into our affordable luxury offerings. A new emphasis on sustainability, including eco-friendly packaging and organic products, is fast becoming part of our culture.

Criteria #4: Conservative Debt

While taking on some debt is a good strategy to raise cash for expansion, taking on too much debt can lead to bankruptcy during a prolonged recession or poor cash flow management.

It is important to ensure that the amount of money borrowed by the company is conservative and can be easily paid back within three to four years. The rule of thumb is that long-term debt should be less than 3 times Current Net Income (after tax).

Long Term Debt < (3 to 4) x Current Net Earnings (After Tax)

The company's long-term debt can be found in its balance sheet under 'long term liabilities' or 'non-current liabilities' and as you know, Net Income can be found in the Income Statement. Let's look at the Wal-Mart example.

Table 6: Balance Sheet from Morningstar.com

Screen capture from www.morningstar.com

Wal-Mart Stores WMT

10-Yr Income | 10-Yr Cash Flows | **10-Yr Balance Sheet** | 5-Yr Restated | Quarterly Results

Balance Sheet — As originally reported

Assets $Mil

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	latest Qtr
Cash and Equiv	883.0	1,447.0	1,879.0	1,856.0	2,054.0	2,161.0	2,758.0	5,199.0	5,488.0	6,414.0	5,908.0
Short-Term Investments	---	---	---	---	---	---	---	---	---	---	---
Accts Rec	845.0	976.0	1,118.0	1,341.0	1,768.0	2,000.0	2,108.0	1,254.0	1,715.0	2,662.0	2,477.0
Inventory	15,897.0	16,497.0	17,076.0	19,793.0	21,442.0	22,614.0	24,891.0	26,612.0	29,447.0	32,191.0	38,531.0
Other Current Assets	368.0	432.0	1,059.0	1,366.0	1,291.0	1,471.0	726.0	1,356.0	1,841.0	2,557.0	2,707.0
Total Current Assets	**17,993.0**	**19,352.0**	**21,132.0**	**24,356.0**	**26,555.0**	**28,246.0**	**30,483.0**	**34,421.0**	**38,491.0**	**43,824.0**	**49,623.0**
Net PP&E	20,324.0	23,606.0	25,973.0	35,969.0	40,934.0	45,750.0	51,904.0	58,530.0	68,567.0	79,290.0	86,022.0
Intangibles	---	---	---	9,392.0	9,059.0	8,595.0	9,521.0	9,882.0	10,803.0	12,188.0	13,257.0
Other Long-Term Assets	1,287.0	2,426.0	2,891.0	632.0	1,582.0	860.0	2,777.0	2,079.0	2,362.0	2,885.0	2,217.0
Total Assets	**39,604.0**	**45,384.0**	**49,996.0**	**70,349.0**	**78,130.0**	**83,451.0**	**94,685.0**	**104,912.0**	**120,223.0**	**138,187.0**	**151,119.0**

Liabilities and Stockholders' Equity $Mil

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	latest Qtr
Accts Payable	7,628.0	9,126.0	10,257.0	13,105.0	15,092.0	15,617.0	17,140.0	19,332.0	21,671.0	25,373.0	29,263.0
Short-Term Debt	618.0	1,141.0	1,006.0	5,408.0	6,661.0	3,148.0	5,793.0	6,367.0	7,781.0	8,648.0	13,758.0
Taxes Payable	298.0	565.0	501.0	1,129.0	841.0	1,343.0	739.0	1,377.0	1,281.0	1,340.0	252.0
Accrued Liabilities	2,413.0	3,628.0	4,998.0	6,161.0	6,355.0	7,174.0	8,945.0	10,342.0	12,155.0	13,465.0	14,283.0
Other Short-Term Liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	607.0
Total Current Liabilities	**10,957.0**	**14,460.0**	**16,762.0**	**25,803.0**	**28,949.0**	**27,282.0**	**32,617.0**	**37,418.0**	**42,888.0**	**48,826.0**	**58,163.0**
Long-Term Debt	10,016.0	9,674.0	9,607.0	16,674.0	15,655.0	18,732.0	19,608.0	20,099.0	23,669.0	30,171.0	27,776.0
Other Long-Term Liabilities	1,488.0	2,747.0	2,515.0	2,038.0	2,183.0	2,335.0	3,123.0	3,772.0	4,270.0	6,019.0	6,417.0

Long-Term Debt
$30.17 billion

Wal-Mart's balance sheet (Table 6) tells us that it has long-term debt of $30.171 billion in 2006. If you look back at the income statement (Table 3), you can see that 'Net Income' is $11.231 billion. So since, Wal-Mart can easily pay back all its debt with less than three years of its income, it passes the conservative debt criteria.

Criteria # 5: Return of Equity (ROE) Must Be Consistently Above Average (i.e. ROE > 15%)

Return on Equity (ROE) shows you how much profits a company is generating with the money shareholders have invested in it. ROE is derived from dividing Net Income by Shareholders' Equity.

$$\text{Return on Equity (ROE)} = \frac{\text{Net Income}}{\text{Total Shareholder's Equity}} \times 100\%$$

ROE is a very important figure to look at as a company that shows a high & consistent ROE indicates that:

- The company has a sustainable competitive advantage.
- Your investment in the form of shareholders' equity will grow at a high annual rate of compounding that will lead to a high share price in the future.

Generally, a company that has a ROE of 12% is considered a fair investment. Companies that are able to generate a ROE of more than 15% consistently are very rare and considered great investments.

Because ROE is so commonly used in evaluating companies, you usually do not have to calculate it yourself. ROE figures are usually presented in a company's annual report under 'Financial performance summary' or under 'financial ratios'. You can easily find a company's history of ROE from www.morningstar.com under 'key ratios'. You can see from table 7, that Wal-Mart again easily passes this criterion by having an ROE that is consistently above 20%.

Table 7: 'Key Ratios' from Morningstar.com

Screen capture from www.morningstar.com

Profitability	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM
Tax Rate	37.0%	37.0%	37.4%	36.7%	36.5%	36.2%	35.3%	36.1%	34.7%	33.4%	33.8%
Net Margin	2.91%	2.99%	3.22%	3.26%	3.29%	3.06%	3.29%	3.53%	3.60%	3.59%	3.23%
Asset Turnover (Average)	2.72	2.78	2.89	2.74	2.58	2.70	2.75	2.57	2.53	2.42	2.40
Return on Assets	**7.92%**	**8.30%**	**9.29%**	**8.94%**	**8.48%**	**8.26%**	**9.03%**	**9.07%**	**9.12%**	**8.69%**	**7.73%**
Financial Leverage (Average)	2.43	2.38	2.41	2.55	2.61	2.44	2.39	2.41	2.42	2.52	2.61
Return on Equity	**19.23%**	**19.76%**	**22.39%**	**22.75%**	**22.11%**	**20.11%**	**21.59%**	**21.83%**	**22.07%**	**21.87%**	**20.15%**

Criteria #6: Low Capital Expenditure (CAPEX) required to Maintain Current Operations

Watch out for companies that generate high earnings BUT a substantial portion has to go back into replacing plant & equipment in order to maintain its current operations. Price-competitive businesses and capital-intensive industries (e.g. Manufacturing, airlines, automobile makers etc…) need to have to spend a lot of their earnings to make their businesses even more cost efficient. Since re-investment of profits is not considered an expense but an asset, these companies' income statements make it seem like they are making lots of money. But in reality, there is no cash left to be paid back to shareholders or to invest in new products or markets that will drive growth.

This is why Warren Buffett avoids companies that require high capital expenditure to maintain current operations. He likes to invest in businesses that do not require much replacement of machinery, do not require intensive research and produce a product that never goes obsolete. Companies like Coca-Cola (one of Warren core holdings) have a product (i.e. Coke) that never goes obsolete. It can therefore take almost all of its cash from earnings and use it to pay dividends or to invest in building new stores and entering new markets. Similarly, Nike does not own its factories and does not have to spend chunks of its profits to replace expensive machinery, thus making it cash rich.

This criterion is more qualitative rather than quantitative. In other words, you don't have to use a specific formula to get a number that will tell you the answer. You can make an educated guess by understanding the business model of the company's stock you are buying.

In the case of Wal-Mart, it does not have to use a significant amount of cash to constantly replace plant or machinery, nor does it have to constantly upgrade all its stores every year. It is thus able to spend a large amount of its cash flow for expansion purposes.

Criteria #7: The Management is Holding or Buying the Company Stock

The next factor to look at is whether the company's own directors are holding, buying or selling their own shares. If you find that key appointment holders like the CEO, CFO or chairman are selling a

large proportion of their own stock, then it may not be as good an investment as it seems. Think about it. If the company's own directors don't have faith in their own stock, how can you? At the same time, if you find that management is buying a large amount of company stock, it means that they have confidence that they are getting a good deal at the current price. Who else would know the company's value better than the people who are running it?

You can easily find out recent insider trades by going to www.moneycentral.com. Under the section on 'Insider Trading', you can find all the information related to the stock purchases, sales and current holding of the company's employees.

Table 8: 'Insider Trading' Activity for Wal-Mart

Screen capture from www.moneycentral.com

Recent Insider Trading Activity: Wal-Mart Stores, Inc.

Date	Name	Transaction	Num Shares	Price(s)	Value
03/27/07	BREYER JAMES W	Purchased	5,000	$47.41	237,050.00
03/22/07	SHEWMAKER JACK C	Sold	21,030	$48.05	1.01 Mil
12/15/06	MENZER JOHN B	Sold	33,879	$46.67	1.58 Mil
12/13/06	MCMILLON C DOUGLAS	Sold	2,701	$45.93	124,056.93

Insider filings are updated daily and are based on forms filed monthly with the SEC.

"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

Wal-Mart Stores, Inc.: Insider Trading

The following transactions were listed on a Form 4 document filed with the SEC.

Transaction Detail	back to Transactions Overview
Name	SHEWMAKER JACK C
Title	Director
Remaining Shares	3 Mil
Trade Date	03/22/07
Transaction	Sold
Quantity	21,030
Price	$48.05
Value	$1.01 Mil

Insider filings are updated daily and are based on forms filed monthly with the SEC.

"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

From Table 8, you can see that WMT fares neutrally under this criterion. There were three company employees selling their shares and one buying. However, there is no cause for panics as the proportion of shares being sold is relatively small (maybe they wanted to buy a new house for Christmas) and the insiders who were selling were not key appointment holders or senior management.

If the stock you are evaluating passes the first seven criteria, it means that you have found a great business that is financially strong and will continue to grow in value. Just like finding a beautiful jacket in a department store that fits you perfectly, you would want to make sure you are getting a great deal on the price before you make the purchase. The next two criteria will tell you if it is the right time to buy.

Criteria #8: The Stock is Undervalued: Share Price is Significantly Below Intrinsic Value

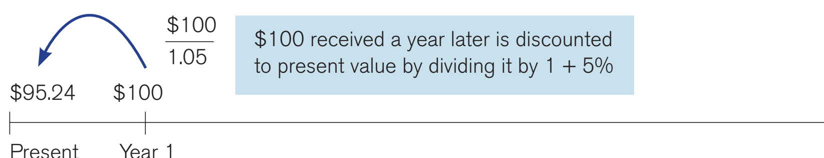
Before you be sure if you are buying at a good price, you must know how much the company is really worth. So, how do you calculate the intrinsic value of a stock?

Let me explain using an example. (For those who have read 'Secrets of Self Made Millionaires, forgive me for repeating this). Think of this question, 'What is the most you would pay for a machine that would generate $100 today?' The answer is $100! If you paid $100 for a machine and it generates back $100, you would breakeven. So, $100 is the most you would pay.

Now, what is the most you would pay for a machine that will generate $100 in one year? Would you pay $100? Of course, not! You would definitely pay less than $100, as you would have to wait a year to get your $100 back. So, what is the maximum you would pay today? The answer depends on the risk free interest rate, which is usually measured by 3-month US Treasury Bills.

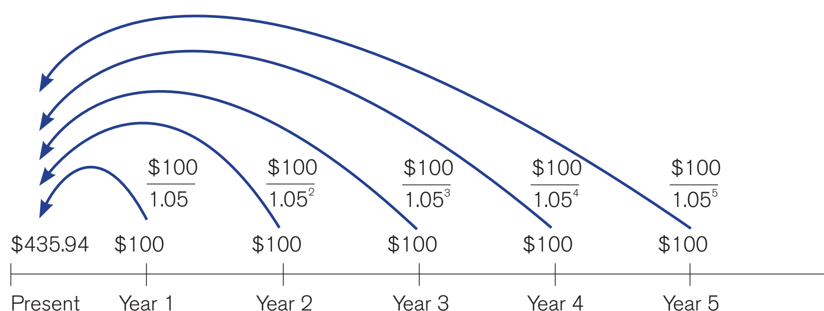
If the risk free rate is 5%, then you would pay a maximum of $95.24 ($100/ (1+ 0.05)) for the machine today. Why? Well, if you were to put that $95.24 in a risk free investment earning 5%, you could get $100 a year later. So, $95.24 is the present value you would place on $100 to be received a year later. In other words, money received in the future is worth less today. To find out the present value

of $100 received in one year, we divide it by 1+0.05 (risk free rate) to get $95.24. This is known as discounting future value to present value.



$100 received one year later is worth $95.24 today.

Now, how much would you pay for a machine that will generate $100 in one year, $100 in the second year, $100 in the third year and so on till the fifth year? To find the answer, you would have to discount each future payment to its present value.



$100 received in year 1 will be worth $100/1.05 = $95.24 today
$100 received in year 2 will be worth $\$100/1.05^2$ = $90.70 today
$100 received in year 3 will be worth $\$100/1.05^3$ = $86.38 today
$100 received in year 4 will be worth $\$100/1.05^4$ = $82.27 today
$100 received in year 5 will be worth $\$100/1.05^5$ = $78.35 today

So, the present value of the entire five payments would be worth $435.94 today ($95.24+$90.70+$86.38+$82.27+$78.35). The value of the machine will be worth a maximum of $435.94 today.

Similarly, when you buy a stock, you are buying part of a company that would generate cash every year, year after year. Therefore…

The Intrinsic Value of a Stock is Equal to the Present Value of All Its Future Cash Flow from Operations.

In theory, the intrinsic value of a company is calculated by adding up all its future operating cash flow to perpetuity and then discounting it to the present value. However in reality, companies do not last forever. To be very conservative, assume that the company will only last for ten more years. So, we will calculate the intrinsic value of a stock by adding up all the projected cash flow from operations over the next ten years and discounting it to the present value.

Calculating the Intrinsic Value of Wal-Mart Stock

Let's once again take the example of Wal-Mart and calculate the intrinsic value of the stock in the year 2006. Before we can project the operating cash flow for the next 10 years, we have to calculate the average annual operating cash flow growth rate over the last 5 years as an indication. By using a financial calculator, you can easily find that operating cash flow grew by 11.44% annually for the past 5 years. So, we will assume that operating cash flow will continue to grow at least 11.4% over the next 10 years.

How DO You Calculate the Operating Cash Flow Growth Rate?

By going back to the statement of cash flows (Table 2), you can easily find the 'operating cash flow' (cash from operations) of the company for the last 5 years. For Wal-Mart, it is as follows:

Yr 2001	$9,604m	Yr 2004	$15,996m
Yr 2002	$10,260m	Yr 2005	$15,044m
Yr 2003	$12,532m	Yr 2006	$17,633m

Using a financial calculator, we can easily calculate the average annual compounded growth rate of cash flow over the last 5 years. First, set it to 'compound interest mode'. Then key in the following:
PV: -$9,604, FV: + $17,633, N: 5, P/Y: 1, C/Y:1, PMT:0
SOLVE for 'I'. You should get '11.4%'
This means that on average, cash flow from operations has been growing at 11.4% annually for the last 5 years.

PV: Present value. FV: Future value. N: Number of periods. P/Y: Number of payment periods a year. C/Y: Number of compounding periods a year. PMT: Payment per period. I: Rate of return.

Projecting Operational Cash Flow for the Next 10 Years (CF Proj)

Since the cash flow from operations is $17,633m in 2006, we can project that it will be $19,643m in 2007, $21,882m in 2008, $24,377m in 2009 and so on (just increase it by 11.4% each year). This can be seen in Table 9 under 'Cash Flow (Projected)'.

Calculating a Discount factor (DF)

Now, remember that money received in the future is worth less today. So, we have to discount all future cash flow by a discount factor. Taking a very conservative risk free rate of 5%, the discount factors (DF) are derived by dividing 1 by 1.05^n, where 'n' is the number of years to be discounted. Thus the discount factors you can see in Table 9 below are 0.95 ($1 \div 1.05$), 0.91 ($1 \div 1.05^2$), 0.86 ($1 \div 1.05^3$) and so on.

Discounting all Future Cash Flows to Present Value (DV)

The 'Discounted Value' of all the future cash flows (DV) is derived from multiplying the projected cash flow with the discount factor (DV = Cash Flow (Projected) x Discount Factor). From Table 9, you can see that the discounted values (DV) of all the future cash flow are worth $18,707m, $19,848m, $21,057m, $22,341m and so on.

Table 9: Calculating Intrinsic Value for WMT

Intrinsic Value Calculator (Discounted Cash Flow Method 10 years)

(Be consistent with the denominations used. Usually Millions $)

KEY IN THE VALUES IN WHITE BOX

Name of Stock	Wal-Mart
Stock Symbol	WMT
Operating Cash Flow (current)	$17,633.00 millions
Cash flow growth rate	11.40%
No. of Shares Outstanding	4,188.0 millions

PV of 10 yr Cash flows	$247,689 milion
Intrinsic Value per share	$59.14

Current Year	2006	NB: Take the last Fiscal Year as the Current Year
Discount Rate	5%	NB: Use the 3 months US Treasury Rate

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Cash Flow (Projected)	$19,643.16	$21,882.48	$24,377.09	$27,156.07	$30,251.87	$33,700.58	$37,542.44	$41,822.28	$46,590.02	$51,901.29
Discount Factor	0.95	0.91	0.86	0.82	0.78	0.75	0.71	0.68	0.64	0.61
Discounted Value	$18,707.77	$19,848.06	$21,057.84	$22,341.37	$23,703.13	$25,147.89	$26,680.71	$28,306.97	$30,032.34	$31,862.89

Note: This assumes EPS growth rate remains constant throughout the 10 years
In certain cases, you may want to lower or increase the growth rate after a few years.

The intrinsic value of the whole company (i.e. Wal-Mart) would be the sum of all the future 'Discounted Cash Flow' for the next 10 years
= Add up all the Discounted Values
= \$18,707.77m+\$19848.06m+ \$21,057.84m+........+\$31,862.89m
= \$247,689 million (PV of 10yr Cash Flows)

Now that we know how much the whole company is worth, how much is one share of stock worth?

To get the intrinsic value of one stock, take \$247,689 million and divide it by the total number of shares outstanding (i.e. 4188 million shares). So,

$$\textbf{the intrinsic value of one stock} = \frac{\$247{,}689 \text{ million}}{4{,}188 \text{ million}} = \$59.14$$

As I am writing this book (Jan 2007), Wal-Mart shares are trading at \$46, which means that they are priced 22% below their intrinsic value of \$59.14. So, this great stock is indeed undervalued.

The good news is that I don't expect you to do all this calculation manually. I have created a Microsoft Excel Template where you have to just key in 'projected cash flow growth rate', 'current operating cash flow' and 'number of shares outstanding' and the intrinsic value per share will be automatically calculated for you. You can download this template for free at www.thewaytomakemoney.com/tools.html under 'Free Business and Money Making Downloads'.

Note: If you go to some research sites like www.morningstar.com, you would usually see a much higher intrinsic value given to the stock. This is because most stock analysts take the present value of all future cash flows to perpetuity. By taking cash flow for only the next 10 years, I am being extra conservative.

Criteria #9: Stock Price is Consolidating or on an Uptrend

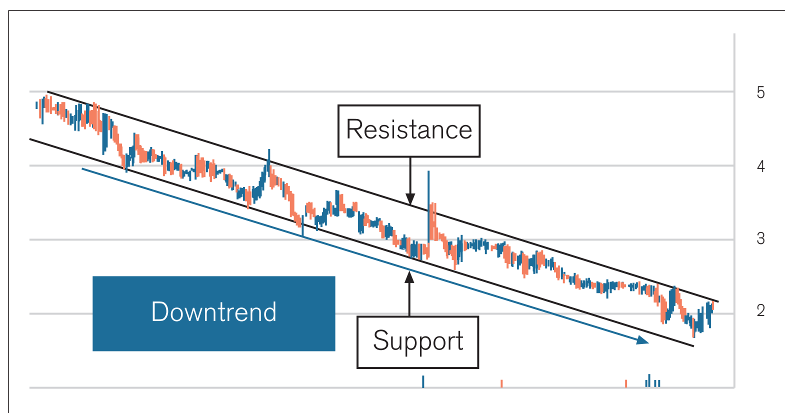
The last crucial factor to look at is the behaviour of the stock's price and the volume of shares that are traded over a period of time. We can find this by looking at the stock's price chart. How the stock price has been moving gives us an important insight into the psychology that

investors have towards this stock. By looking at the stock's historical price movements, we can make more educated predictions as to how the stock will behave in the near future. The study of patterns in the price of a stock is known as technical analysis. You can easily find a stock's chart by going to financial sites like www.moneycentral.com or on your online broker's site. I prefer using the charts of my online broker www.optionsxpress.com as they come with a lot more advanced features.

Remember in the previous chapter we learnt that a stock's price moves in three basic ways. It can move on an uptrend, it can move on a downtrend and it can consolidate (move sideways).

When a stock is moving on a downtrend it means that investors are still very pessimistic about the stock. There are many more people wanting to sell the stock than people wanting to buy the stock. This constant selling pressure leads the stock to move lower and lower. Although value investors want to buy undervalued stocks when it is 'unpopular' and 'overlooked' by the general investment community, it is never ever a good idea to buy when the stock is still in a downtrend.

Chart 3: Stock Price on a Downtrend



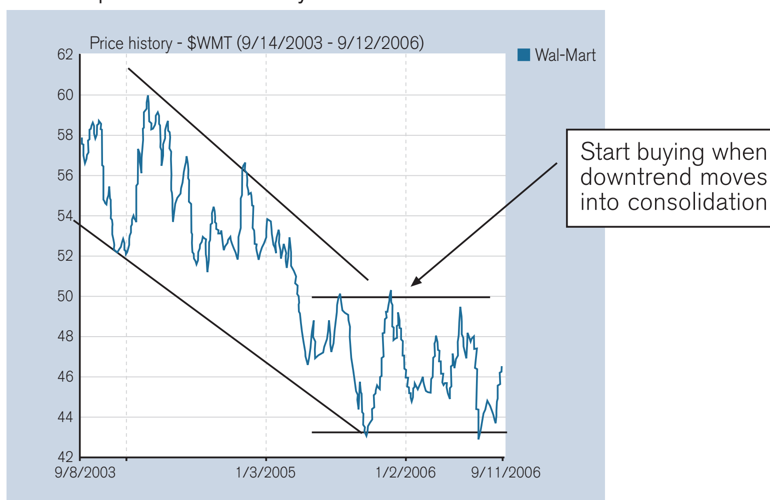
The simple reason is because it is highly likely that the stock price will continue to move lower and there is no telling how low it will go before the selling pressure subsides. Remember, a stock's price will be more likely to continue in the direction of a trend until there is a change in investor sentiment, which results in a trend reversal.

As a stock moves lower and lower down on a downtrend, there will come a time when sellers have pushed the stock to a price where an increasing number of buyers will start to re-emerge. This new interest in the stock and buying pressure will prevent the stock from moving any lower.

When the number of buyers begins to match the number of sellers, the stock will start to move in a sideways fashion. The stock price is said to be in a consolidation pattern. This is when it moves up and down in between an imaginary upper (resistance) and lower (support) line. Every time it gets near the upper price limit, it bounces back down again. Similarly, when the stock moves near a lower price limit, buyers push it back up again.

Chart 4: After a Downtrend, Wal-Mart's (WMT) Stock Price Begins a Consolidation Pattern.

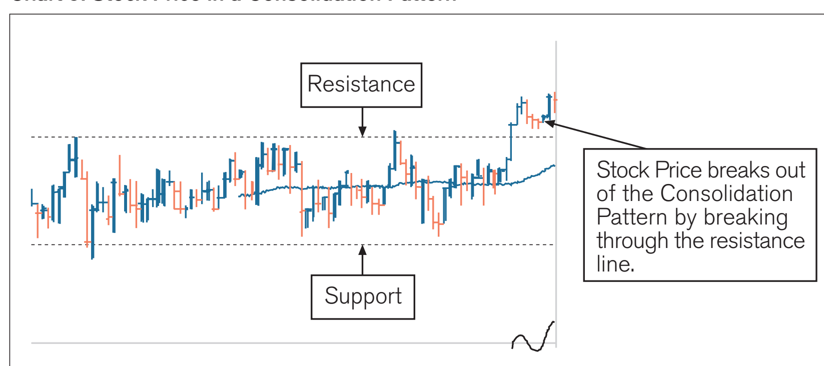
Screen capture from www.moneycentral.com



"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

If the stock is truly a good company that has been oversold because of short-term bad news that caused its initial downward slide, there is a strong likelihood that the stock will eventually breakout of the consolidation pattern and start an uptrend (see chart 5). Buying a great undervalued company in a consolidation phase is pretty safe as the stock price will probably not move any lower. In fact, there is a

Chart 5: Stock Price in a Consolidation Pattern

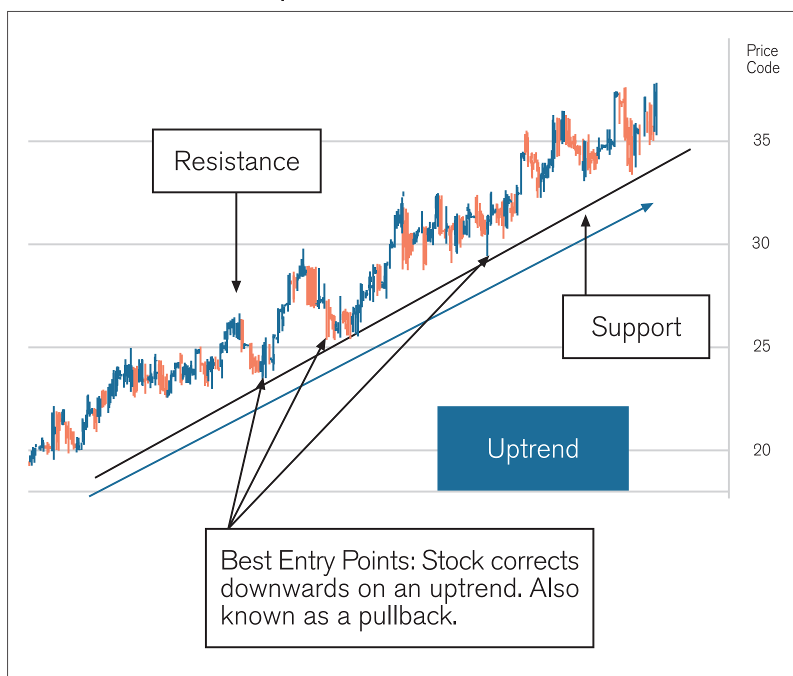


high chance that it will begin to reverse into an uptrend.

So what if the stock you have identified is already on an uptrend? When the stock is already in an uptrend, it means that investors are already optimistic about the stock and there are a lot more people interested in buying the stock than people wanting to sell. This buying pressure causes the stock price to move higher and higher. Since the upward trend is already in place, you can also make your purchase (although you may want to buy when the price goes through a small pullback). If the stock is still undervalued, then it is very likely that the uptrend will continue!

Do remember that even when a stock is on an uptrend, it still moves up and down along the imaginary resistance and support lines. So, the best time to buy a stock when it is on an uptrend is when it pulls back towards the support line. In other words, wait for the stock price to correct downwards before making an entry!

Chart 6: Stock Price on an Uptrend



Again, you can look at the stock price charts by going to www.moneycentral.com or www.optionsxpress.com. Look at the 6 months, 1-year, 5-year and 10-year charts to determine the various trends over different periods of time. Usually, a long-tern trend is stronger than a short-term one.

The Importance of Looking at Volume of Shares Traded

Besides looking at the way a stock's price moves, you must also look at the total number of shares being bought and sold during the same period. The volume of traded shares is represented by vertical bars that appear at the bottom of a stock chart (see chart 7). Looking at a stock's volume together with the price movement can give you more insight into how strong or weak a trend is.

Chart 7: Price Chart of AIG with Volume

Screen capture from www.moneycentral.com

"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

A High Volume Represents a Strong Trend

In general, a higher volume of shares being traded indicates a stronger trend. You can tell that a stock is on a strong uptrend is when volume expands as the price moves up and volume contracts on days when the price moves down slightly.

A strong downtrend is indicated when volume expands as the stock price declines and the volume contracts on days when the stock price moves up slightly.

When Volume Does Not Follow Trend, Watch for Reversals

When the volume of shares being traded starts to decline during an uptrend, it could mean that less and less people are buying up the shares. This is usually an indication that the uptrend will soon end and there could be a possible reversal into a consolidation phase or a downtrend. Similarly, if the volume of shares traded starts to decline during a downtrend, it means that there are less people selling the shares and pushing the price downwards. This is a possible indication that the downtrend will soon end and there could be a possible reversal into a consolidation phase or into an uptrend.

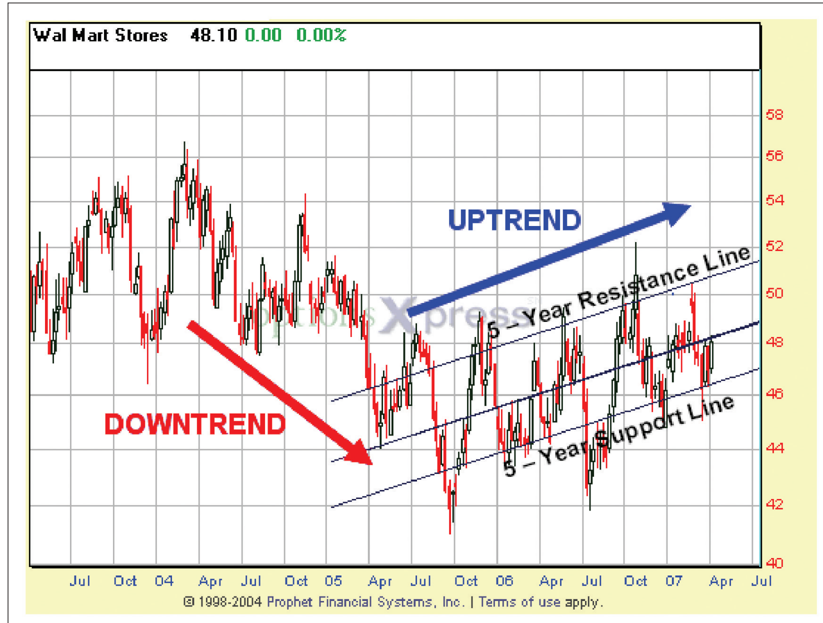
Does Wal-Mart Pass the 8th Criteria?

Armed with this understanding, let's take a look at the price chart of Wal-Mart (WMT). It is always important to look at a long-term perspective (5-year chart) and a shorter-term perspective (6-month chart).

When you look at the WMT 5-year Chart (Chart 8a), you can see that WMT is currently on a long-term uptrend and the stock price is near the middle of the support and resistance lines.

Chart 8a: Price Chart of Wal-Mart (Last 5 Years)

Screen capture from www.optionsxpress.com



When you look at the WMT 6-month Chart (Chart 8b), WMT's stock price is also on a short-term uptrend.

Chart 8b: Price Chart of Wal-Mart (Last 6 Months)

Screen capture from www.optionsxpress.com

So technically, it is a relatively safe time to enter into an investment.

A Quick Word On Charts

Before we move on any further, I would like to take a short detour and talk a bit about the different kind of stock charts that were presented over the last two chapters. While all stock charts shows how the stock price (plotted on the vertical axis) moves over different time periods (plotted on the horizontal axis), there are different ways in which the stock price can be represented. The three most common types of charts are the line chart, the bar chart and the candlestick chart.

The Line Chart

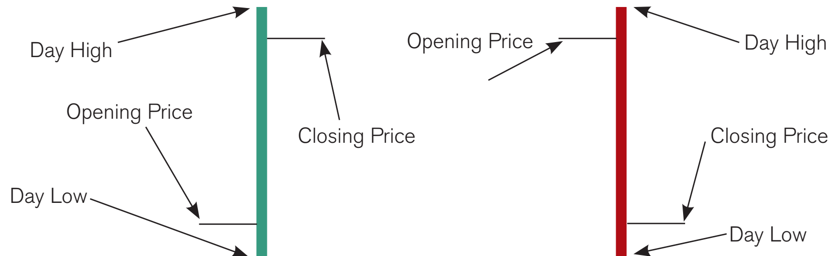
The Line Chart (as shown in chart 9a) is the most simple type of chart as it is only able to show you the closing prices of the stock over a period of time. A continuous line joins the daily closing prices of the stock.

Chart 9a: Line Chart of Goldman Sachs (GS) Oct- Dec 2006

Screen capture from optionsxpress.com

The Bar Chart

The Bar Chart (as shown in chart 9b) is able to display a greater amount of information, including the stock's opening price, closing price, highest price and lowest price. You can look at a chart with daily bars or with weekly bars. The length of the bar shows the relative price range over the day (or week). The top of the bar records the day's (or week's) high price and the bottom of the bar records the day's (or week's) low price. A tick mark on the left represents the opening price of the day (or week) and the right tick mark represents the closing price of the day (or week).



A Green Bar indicates that the stock's closing price is above its opening price.

A Red Bar indicates that the stock's closing price is below its opening price.

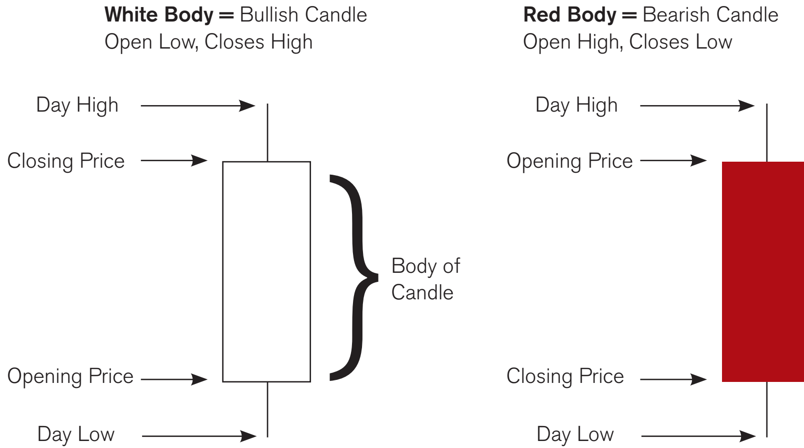
Chart 9b: Bar Chart of Goldman Sachs (GS) Oct- Dec 2006

Screen capture from optionsxpress.com

The Candlestick Chart

The Candlestick Chart (as shown in chart 9c) is the most popular and powerful form of charting today. Although it provides the same kind of information as the bar chart, it is presented in such a way that makes it easier for traders to spot patterns that are used to predict future price movements with a high degree of accuracy. Here is how to read it. When the candle is white, it means that the stock's closing price is higher than the opening price (i.e. stock price rose for the day). For white candles, the opening price is at the bottom of the candle's body and the closing price is at the top.

A red candle means that the stock's closing price is lower than its opening price. For red candles, the opening price is at the top of the body while the closing price is at the bottom.



Reading Candlestick formations and using them to predict future price movements is beyond the scope of this book but it is thoroughly covered in our live Wealth Academy™ and Wealth Academy™ Investor seminars.

Chart 9b: Candlestick Chart of Goldman Sachs (GS) Oct- Dec 2006

Screen capture from optionsxpress.com

What if You Find a Great Business but at the Wrong Time?

So, what do you do if you find a great company that passes the first seven criteria but fails the last two? For example, you may find that the stock price is currently above the intrinsic value and the company is hence overpriced. It's like meeting the girl (or guy) of your dreams with all the right qualities only to find that they are currently in a relationship. Well, what you could do would be to wait for the opportune moment when their relationship went into a bad patch, and you could then move in for the kill! Bad patches happen in all relationships. It's only a matter of time.

Similarly, when you find that great company that is being overpriced in the market, put it on your watch list and wait for the next disaster to strike! Wait for the company to miss one of its quarterly forecasted earnings, wait for the economy to dip, wait for the stock market to go through its usual correction or wait for the US to launch another war. Something bad will always happen that will jolt investor's confidence in a stock's price, no matter how great a company is. When that happens, let the market over-react, pushing your great business down to a price where it is undervalued. This is the time you can go in any go for the kill while the animal is weak.

However, remember to always wait for the downtrend to end and only buy when the stock price starts to stabilize into a consolidation pattern or when it starts to reverse back into an uptrend!

The best investors in the world stay by the sidelines when optimism is high and stocks are expensive. It is during this time that they do most of their research to identify the strongest and fastest growing businesses around. They save all their money for the time when the market is weak. That is when they start buying up all those great companies for a song.

Strategies for Selling Value Stocks

The next most important question people ask is when they should sell the stock to take their profits. When you need the money? When the price has gone up by 20%? 50%? 100%? Well, as a value investor, you cannot just look at the price to determine if the stock should be sold. You must look at the price in relation to the intrinsic value of the stock. Even if a stock price increases by twenty times, you should still

not sell if it is undervalued. This is because when you own the stock of a company that is consistently increasing its earnings & cash flow, the value of your stock will keep increasing over time! By holding on to your shares of stock, you enjoy the power of compounding.

Warren Buffett is often quoted as saying that his favorite holding period is… forever! This is because he knows that as long as the company remains to be great at expanding its business and profits each year, his wealth will keep on compounding. For example, I first bought stock in Osim International (maker of health products) in 2001 at an average price of $0.46. Two years later (2003), when the price doubled to $0.90, many of my friends thought it had gone up so high, it cannot go any higher, so they sold for a profit. Using the Discounted Cash Flow Model, I found that the intrinsic value of Osim stock was $1.70. This means at $0.90, it was still highly undervalued at a 47% discount. Instead of selling, I bought even more stock at $0.90. Here is an extract of how I came to an intrinsic value of $1.70…

Table 10: Intrinsic Value of Osim (Calculated in 2003)

			INTRINSIC VALUE CALCULATOR (CASH FLOW 10 years) (Be consistent with the denominations used. Usually Millions $)							
Cash Flow (current)	$21.00									
Cash flow growth rate	20.00%									
Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Cash flow (Projected)	$25.20	$30.24	$36.29	$43.55	$52.25	$62.71	$75.25	$90.30	$108.36	$130.03
Discount Factor	0.96	0.92	0.89	0.85	0.82	0.79	0.76	0.73	0.7	0.68
Discounted Value	$24.19	$27.82	$32.30	$37.01	$42.85	$49.54	$57.19	$65.92	$75.85	$88.42
PV of 10 yr Cash flows		$501.08								
No. Shares Outstanding		295.37								
Intrinsic Value per share		$1.70								

Today, as I am writing this book (Jan 2007), the last stock price was $1.42, giving me a return of 57% from the time I purchased it at $0.90 and a 215% return ever since I first purchased it at $0.45.

So under what circumstances should you sell the value stock that you own? Here are the sell rules that the greatest value investors follow:

Sell Rule #1: Sell When The Stock Becomes Overvalued

During a strong bull run or during a period of renewed investor optimism, the price of your stock may rise so fast that it begins to overtake its intrinsic value. When you find that your stock is way over-valued, it may be a good time to sell and take your profits.

Sell Rule #2: Sell When the Business is No Longer Great

Even the greatest businesses can lose their greatness one day. This is why you need to regularly review the financial performance and health of the stocks you own once every quarter (when the financial results are released). If you notice a negative change in one of the first seven criteria for value stocks and the change does not seem temporary, then you should sell your shares immediately. For example, you should bail out if the company's management starts to sell a large portion of the stock holdings or if the company somehow loses its sustainable competitive advantage.

Companies experiencing a short-term drop in sales or earnings growth are quite normal so there is usually no need to panic (like most short-term investors do) if your stock reports a decrease in profits in a particular quarter or year. The important thing is to find out the reason for the decrease. Is it a reason that is temporary or permanent? Only sell if you find that the company has been hit by bad news that is permanent and irrecoverable that will prevent it from continuing to increase its sales and profits into the future.

Sell Rule #3: Sell When You Need the Money for a Better Investment

Another reason to sell is if you happen to identify an even better company that is selling at an even bigger discount to intrinsic value. Even though your current stock is still good, you may want to sell, take the proceeds and put it into an even better investment.

Sell Rule #4: Sell When the Stock Reverses into a Downtrend

All great stocks may reverse into a period of downtrend from time to time. It could be the result of some kind of bad news that has hit the company (e.g. new product failure) or the market as a whole or it could just be that professional investors have lost interest in the particular stock or sector for the moment. Even if the company is still great and even if the stock price is still undervalued, I highly recommend that you sell the stock at this time. This is because once a stock goes into a downtrend; there is no telling how low the stock will continue to go.

No matter how great you think the stock is or how cheap the price is, you should not fight the short-term psychology of the market. One thing I have learnt is to never fight a trend, it is just too powerful to be ignored. However, once the downtrend weakens and the stock price begins to stabilize again, it would be wise to re-enter and buy back all your shares at an even lower price!

Sell Rule #5: Sell If the Stock Price Drops 20% Below Your Purchase Price

This final rule is known as a cut loss rule. Although it is usually ignored by emotionally-weak investors, it must be religiously adhered to by all investors who are serious in making consistent profits over time. So, why sell a value stock if its price drops 20% below your initial purchase price? Well, if the stock you are buying is truly undervalued, then it should not drop in value by another 20% or more. If it does, then there could be a possibility that there is something wrong with the company that you do not know. Remember that no matter how great a stock picker you are, you will still make mistakes and pick bad investments. The greatest investors in the world know that they can never be right all the time. The important thing is to minimize their losses when they are wrong and maximize the profits when they are right!

Where do I Begin Finding Great Companies?

So where do you start looking? Obviously, you are going to take forever to find a suitable investment if you just start alphabetically as there are at least 9,000 companies that are actively traded in the US and thousands more on the Asian bourses. Here are a few suggestions on where you can start looking…

1. Start with Looking at Great Products and Great Brands

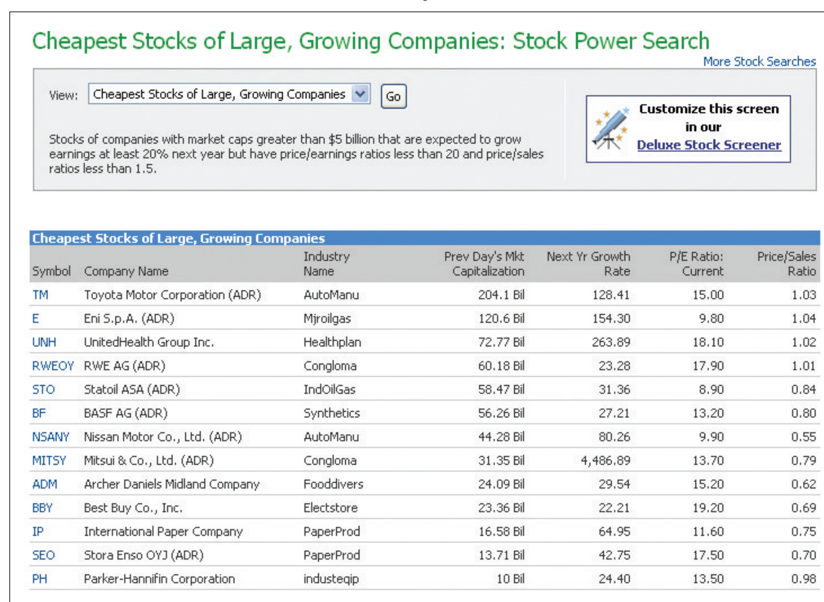
Ask yourself what products or services you buy that you think are consumer monopolies. The next time you go shopping, ask yourself, 'what products must the shops carry?' or 'what are brands that everyone knows and almost everyone has to buy?' These will usually be companies that have a very strong competitive advantage. In fact, most of Warren Buffett's most successful investments were

in companies that made products he loved! These included The Washington Post, Coca-Cola, Nike and Gillette.

2. Search for Top Rated Stocks on Financial Research Sites

On www.morningstar.com, you can start off by looking at their list of five-star rated stocks. This is a paid service but I think that it is worth paying for the knowledge. On www.moneycentral.com, you can use their 'Power Search' tool to instantly find great companies that are undervalued.

Table 11: Power Searches from www.moneycentral.com



Cheapest Stocks of Large, Growing Companies: Stock Power Search

More Stock Searches

View: Cheapest Stocks of Large, Growing Companies Go

Stocks of companies with market caps greater than $5 billion that are expected to grow earnings at least 20% next year but have price/earnings ratios less than 20 and price/sales ratios less than 1.5.

Customize this screen in our Deluxe Stock Screener

Cheapest Stocks of Large, Growing Companies

Symbol	Company Name	Industry Name	Prev Day's Mkt Capitalization	Next Yr Growth Rate	P/E Ratio: Current	Price/Sales Ratio
TM	Toyota Motor Corporation (ADR)	AutoManu	204.1 Bil	128.41	15.00	1.03
E	Eni S.p.A. (ADR)	Mjroilgas	120.6 Bil	154.30	9.80	1.04
UNH	UnitedHealth Group Inc.	Healthplan	72.77 Bil	263.89	18.10	1.02
RWEOY	RWE AG (ADR)	Congloma	60.18 Bil	23.28	17.90	1.01
STO	Statoil ASA (ADR)	IndOilGas	58.47 Bil	31.36	8.90	0.84
BF	BASF AG (ADR)	Synthetics	56.26 Bil	27.21	13.20	0.80
NSANY	Nissan Motor Co., Ltd. (ADR)	AutoManu	44.28 Bil	80.26	9.90	0.55
MITSY	Mitsui & Co., Ltd. (ADR)	Congloma	31.35 Bil	4,486.89	13.70	0.79
ADM	Archer Daniels Midland Company	Fooddivers	24.09 Bil	29.54	15.20	0.62
BBY	Best Buy Co., Inc.	Electstore	23.36 Bil	22.21	19.20	0.69
IP	International Paper Company	PaperProd	16.58 Bil	64.95	11.60	0.75
SEO	Stora Enso OYJ (ADR)	PaperProd	13.71 Bil	42.75	17.50	0.70
PH	Parker-Hannifin Corporation	industeqip	10 Bil	24.40	13.50	0.98

"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

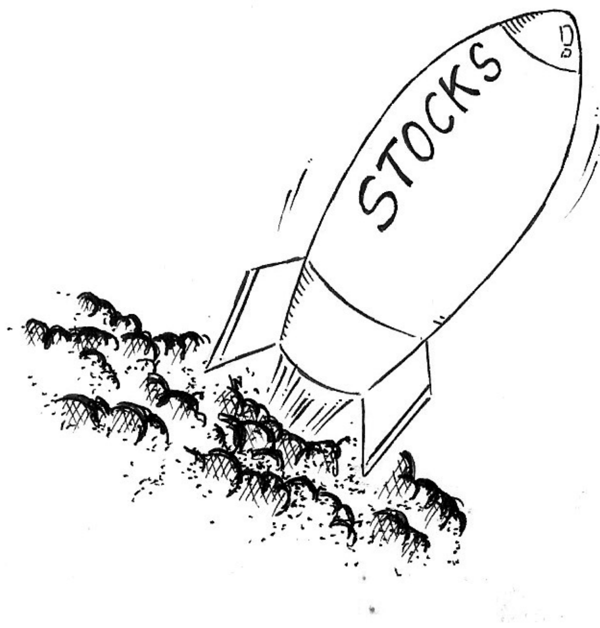
3. Find Out What The Gurus Are Buying

Find out what Warren Buffett has been buying through his company Berkshire Hathaway. You should be able to find his latest purchases by searching for 'Buffett buys' or 'Berkshire buys' under Yahoo!, or Google.

So there you have it! You now have all the knowledge and tools to begin your journey as a value investor who can beat the market in the mid to long term. Let's move your financial intelligence up another notch by learning about the art of momentum investing.

Momentum Investing: Catching Stocks Before They Fly

5


STOCKS

chapter

5

Momentum Investing: Catching Stocks Before They Fly

Welcome to chapter 5!

Congratulations for making it more than half-way through the book. I am impressed by your level of commitment and dedication to become a millionaire investor.

Research has shown that less than ten percent of people who buy a book actually finish it and less than five percent put into practice what they have learnt. What a terrible waste!

Well, I know you are different and you will master all the concepts in this book and start putting your financial freedom plan into action!

In the last chapter, you learned how great investors like Warren Buffett make huge profits in the market by being a contrarian, buying great companies that have undervalued stocks that nobody else wants in the short-term. Then having the patience to sit and wait until the market eventually pushes the stock price up to its true value, making the investor millions of dollars for his foresight.

While value investing can make you consistent profits of 15%–25% annual returns at very low risk, you would have missed out on making huge profits on the following three examples of high performing stocks…

Chart 1: Google Jumped from $190 to $473 in 9 months (148% Return)

Screen capture from www.moneycentral.com

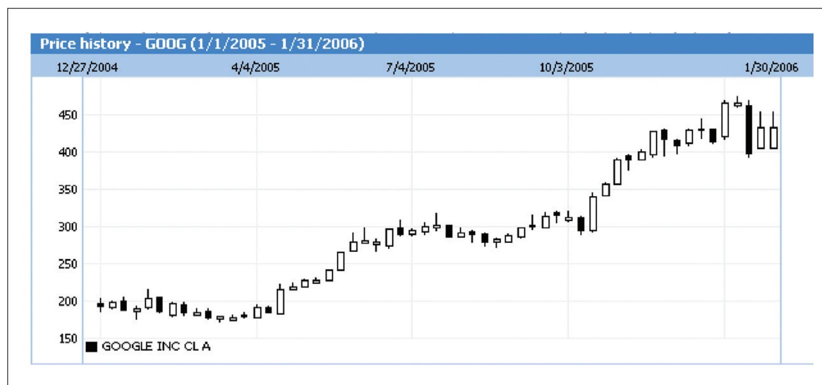


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Chart 2: Empire Resources (ERS) Increase from $10 to $45 in 3 Months (350% Return)

Screen capture from www.moneycentral.com

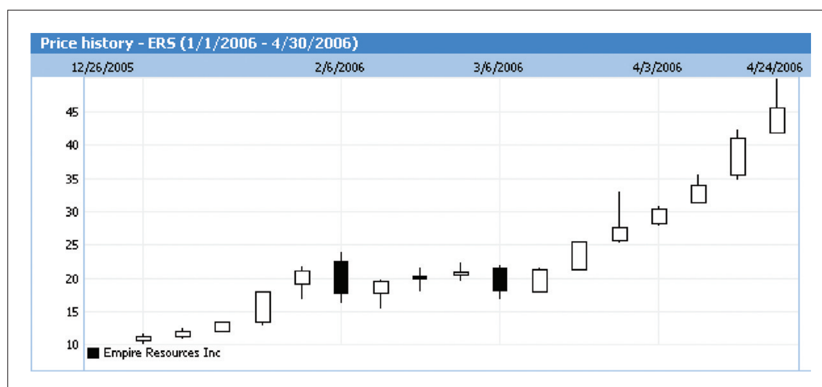

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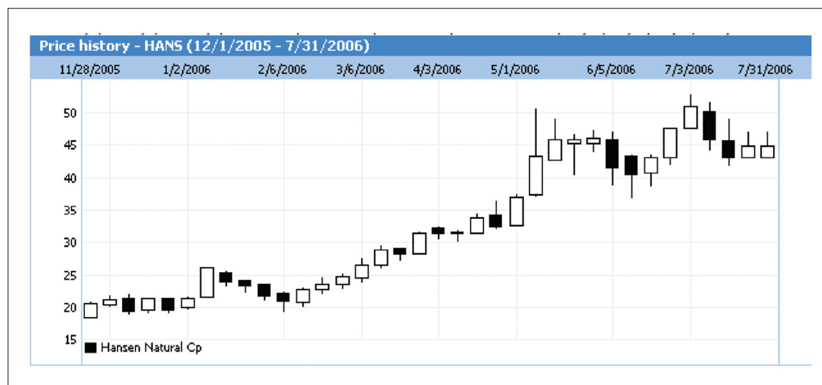
Chart 3: Hansen Natural (HANS) Spiked Up from $20 to $52 in 6 Months (160% Return)

Screen capture from www.moneycentral.com



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The reason you would have missed making huge profits on these three stocks (along with many more high flying stocks) is because they were never undervalued.

In fact, all these three stocks were already priced way past their intrinsic value before they started making their big jump! After their huge price increase, they became even more overvalued than ever before.

These are known as momentum stocks. So why would people still aggressively buy such stocks knowing that they were overvalued?

Well, the simple reason is that the market is made up of investors who are greedy and buy simply because they believe that the stock will go higher and higher. I call it 'the greater fool's theory'.

This theory says that people buy a stock at a ridiculously high price hoping for a greater fool to buy it from them later. The result of all this optimism on a stock and the huge demand for its shares send it higher and higher, despite what it is truly worth.

Momentum stocks that make huge price gains over a short period of time are stocks that are usually 'hot' and 'popular' with fund managers, stock analysts and the general public.

They are the stocks that everybody is talking about and everybody wants to buy (as opposed to value stocks which are ignored or shunned by the market). There is usually lots of hype surrounding the stock

with a barrage of good news (i.e. high earnings growth forecast, new product innovation) driving investor optimism to bid up the stock price to higher and higher levels.

What also causes these momentum stocks to move upwards is also the fact that they are found in 'hot sectors' or 'hot industries' where fund managers pour billions of dollars into. For example, during 1998–2000, the Technology Sector (specifically Internet related stocks) was the rave and fund managers invested billions of investors' money into any stocks that had a dotcom business, even though they were losing money. Causing all stocks within the technology sector to go sky-high despite their true value!

So, if momentum stocks can make us tons of money, then why not invest only in momentum stocks? Why even bother with value stocks? Well, while momentum stocks make huge price gains when they (and the sector they are in) are hot and popular, they do not remain popular forever!

After a while, the stock will start to fall out of favour with stock analysts and fund managers. When a 'hotter' stock or sector comes along, fund managers will start to divert their funds to the new hot stocks in play, causing the once high flying stock to come crashing down!

Because momentum stocks are usually highly overpriced to begin with, any change in market sentiment (i.e. market goes into a downturn, which is pretty common) will cause the stock to freefall just as quickly.

If you think about it, playing with momentum stocks is like being friends with the hottest and most popular girl in school. She may be a lousy friend but her popularity will make everyone else think that you are cool and hot too! However, when she loses her popularity to a sexier and more charming new girl that comes along, you will be stuck with an unpopular & lousy friend no one likes anymore.

Remember the three beautiful and sexy stocks which I showed you just now? Well, you may want to know that while they made investors huge profits in a couple of months, those investors that got in at the wrong time lost their pants. Take a look at how the Empire Resources (ERS) and Hansen Natural's (HANS) stock price moved after its strong advances…

After increasing four fold from $10 to $45 in 3 months, Empire Resources (ERS) fell to $12 in 2 months… ouch! (a 74% drop).

Chart 4: Stock Chart for Empire Resources (ERS)

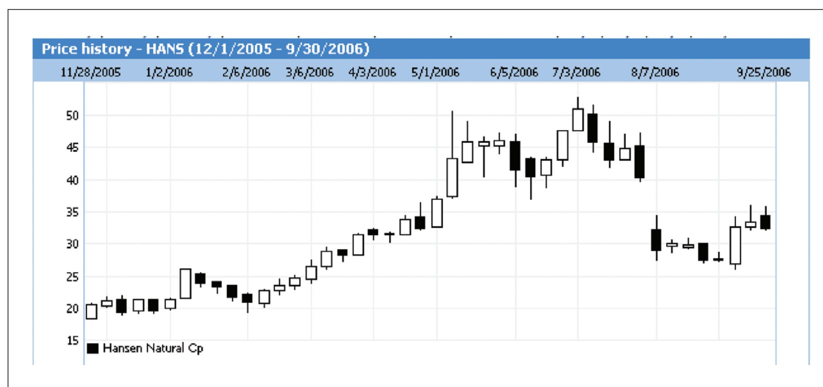
Screen capture from www.moneycentral.com

"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

After Hansen Natural (HANS) increased from $20 to $52 in 6 months, it fell to a low of $26 within 3 months (a 50% fall).

Chart 5: Stock Chart for Hansen Natural (HANS)

Screen capture from www.moneycentral.com



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So, as you can see, while you can make some of your highest returns with momentum stocks, you can also lose everything if you do not buy and sell at the right time.

The Story of the Hare and the Tortoise in Investing

A value stock is like the reliable and hardworking tortoise that will eventually reach the finish line, while a momentum stock is like the hare that can run very fast but could go to sleep anytime and lose the race.

The strategy is to ride on the hare while they are running really fast and jump off before they start going to sleep.

This is why the momentum stock investing strategy requires you to have the highest level of knowledge and competency not just in the financial strength of the company but also in the area of market psychology.

Being able to make money consistently in momentum stocks is all about timing and reading the psychology of the mass market. You must know the exact timing of when fund managers will start pushing the stock up and when they will leave it to come crashing down.

So, can you actually make intelligent predictions on when the market will move a stock? The answer is YES.

While there are never any guarantees and you can never be a hundred percent accurate in an ever changing dynamic market, you can be right the majority of the time by using what is known as Technical Analysis!

While fundamental analysis helps you to determine the financial stability and profitability of the company you are buying, Technical Analysis helps you to understand and predict mass investor psychology towards the stock you are trading.

This is achieved by studying the stock's historical price movements and the volume of the shares being traded. By studying past price patterns, you will find that history tends to repeat itself and you can draw a high level of probability that investors will tend to buy and sell the stocks when it reaches certain psychological price levels.

Technical Analysis is the process of studying securities (e.g. stocks) by analyzing statistics generated by market activity, such as past prices and volume. Technical analysts do not attempt to measure a stock's fundamentals or intrinsic value. They use charts and other tools to identify patterns that can accurately predict future price movements.

The Strategy of the Momentum Investor

In the chapter on value investing, you will recall that the strategy of the value investor includes:

Step 1: Identify great businesses,
Step 2: Buy them only at a huge discount
Step 3: Wait for the market to realize its true value or overvalue it.

Well, as a momentum investor, the strategy is a bit different. The three steps you must take include:

Step 1: Identify great businesses
Step 2: Buy them when they highly rated by the market (usually resulting in the stock being above its intrinsic value)
Step 3: Sell when the stock is overbought, just before investors move out causing the stock to decline.

Momentum Stocks Versus Value Stocks

As you can see from the chart below, momentum stocks can be quite different from value stocks. However, when all the buy and sell rules are adhered to, both strategies can be highly profitable. Here is an overview of the major differences.

One of the more important points to take note of is that in value investing, the probability of loss is much lower. Because value stocks are already so undervalued, a market downturn doesn't usually affects its price very much.

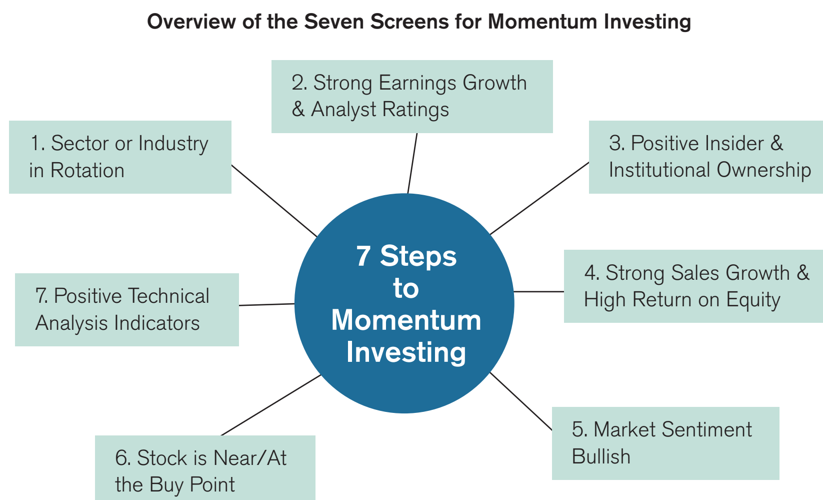
However for highly priced momentum stocks, a slight change in market sentiment or investors' optimism about the stock can cause a sharp drop in value. This risk can be easily managed by selling your momentum stock the moment it drops 10% below your purchase price. This is known as cutting losses and will more than make up for the risk being taken.

Value Investing	Momentum Investing
Usually Mid-Large Cap Blue Chip Companies that have a long history (over 10 years)	Usually Small- Mid Cap Speculative Companies that have a shorter history (less than 10 years)
Target return: 15%-25% per year	Target return: 20%-300% within 3-6 months.
Long-term performance focused. Buy good stock when price is low (bad news). Sell when price is rising (good news).	Short-term performance focused. Buy when price is rising (good news) & sell just before stock falls (bad news).
Buy when stock is undervalued and sell when it is overvalued	Buy when stock is overvalued and sell when stock is overbought (highly overvalued)
Buy when stock is ignored or shunned by investors	Buy when the stock is highly rated and accumulated by investors
Low probability of loss (high margin of safety)	High probability of loss (if you do not cut loss)
Greater Emphasis on Fundamental Analysis	Equal Emphasis on Fundamental Analysis (company) and Technical Analysis (price and volume)

The Seven Screens for Momentum Stocks

So, how do you go about finding great businesses that are highly rated by the market and ready to make significant price moves? Well, there are altogether 7 criteria to help you screen for these rockets that are ready to blast off. Let's look at the overview of the 7 screens for momentum investing.

Overview of the Seven Screens for Momentum Investing



Overview of the Seven Screens for Momentum Investing

As you can see, the criteria for picking a winning momentum stock places a lot more emphasis on market sentiment and investor psychology as compared to investing in value stocks. So, what do all these criteria mean? Let's explore them one at a time.

Screen #1: Sector & Industry in Rotation

In chapter two, you learnt that the entire stock market is divided into different Sectors, which are made up of companies that share the same or related products and services.

For example, the economy is made of the following major Sectors: Health Care, Materials, Energy, Financials, Industrials, Technology, Utilities, Transportation, Consumer Staples and Consumer Discretionary. Each Sector is then further broken down into industry groups. For example, the 'Financial Sector' is further divided into industry groups such as: banks, life insurance companies, asset management, real estate, general insurance companies, consumer finance and so on.

You will also recall that investors (especially fund managers) often move billions of dollars throughout different sectors of the market in anticipation of one sector outperforming another during different phases of the economic cycle.

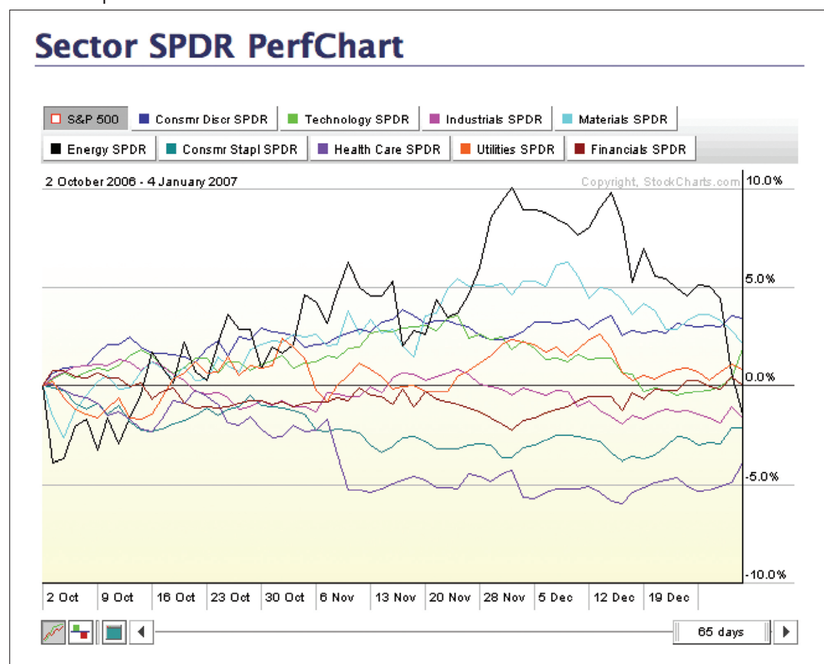
For example, during an economic slowdown, investors will move their money into 'Defensive Sectors' that are more recession proof.

As a result of money pouring into Defensive Sectors like 'Health Care', 'Consumer Staples' & 'Utilities', most of the stocks in this sector will increase in price! At the same time, stocks in all the other sectors such as 'Technology', 'Financials' and 'Industrials' will all start declining as money is moved out! This is called sector rotation. When a sector is in rotation, it means that money is flowing into it causing most of the stocks to jump in price.

Before buying a momentum stock, you have to make sure it is in a sector or industry that is in rotation! In fact, research has shown that that 37% of a stock's move in price is attributed to the industry it belongs to and 12% is attributed to the strength of the sector it is in. High performing stocks thus come from the best performing sectors and industry groups. The best way of finding out is to refer to www.stockcharts.com where you can see which sectors are in rotation (performing better than the S&P 500) and those that are weak.

Chart 6: Comparing the Price Performance of Different Sectors

Screen capture from www.stockcharts.com



"Chart courtesy of StockCharts.com"

You can see from the chart above that as of Jan 2007, the Consumer Discretionary sector is the most consistently high while the Health Care Sector has been the weakest for the last 65 days!

To find out if the momentum stock you are looking at is in a strong performing industry group, you can go to www.moneycentral.com and look under 'Top Performing Industries' as shown below. Note that certain industry groups could be performing very well within a neutral or weak sector.

Table 1: Top Performing Industries

Screen capture from www.moneycentral.com

Industries: January 5

Updated nightly

10 Best Performing Industries

Industry	% Change One Month
Auto Manufacturers - Major	9.1%
Life Insurance	8.7%
Regional Airlines	8.6%
Major Airlines	8.2%
Processing Systems & Products	7.9%
General Entertainment	7.6%
Drug Related Products	7.5%
Marketing Services	7.2%
Security & Protection Services	6.8%
Move Production, Theaters	6.5%

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To summarize, only invest in a momentum stock if it is in a high performing sector or industry group!

Screen #2: Strong Earnings Growth & Analyst Rating

Ultimately it is the market's expectation of a company's ability to generate higher earnings that drive its stock price up and away. The second screen for momentum stocks is a strong record of earnings growth as well as a high earnings forecast for the years ahead.

Almost every financial website can give you this information. However, for consistency, go to www.moneycentral.com, type in the ticker symbol for the stock you are researching on (e.g. Google: GOOG) and click on 'Earnings Estimates' and 'Financial Statements'. There are three main criteria to look at:

1. Positive & Accelerating Earnings Growth of More Than 15% Over The Last 3-5 Years.

In other words, the company's rate of earnings growth should not only be positive but also increasing, especially over the last financial year. In the 'Financial statements' section of moneycentral.com, you can see that Google's total net income (earnings) has been increasing over the last five years.

Table 2: 10-Year Income Statement for Google

Screen capture from www.moneycentral.com

Income Statement | Balance Sheet | Cash Flow | 10 Year Summary

Financial data in U.S. Dollars
Values in Millions (Except for per share items)

Income Statement - 10 Year Summary (in Millions)

	Sales	EBIT	Depreciation	Total Net Income	EPS	Tax Rate (%)
12/05	6,138.56	2,141.68	293.81	1,465.4	5.02	31.58
12/04	3,189.22	650.23	148.47	399.12	1.46	38.62
12/03	1,465.93	346.65	50.19	105.65	0.41	69.52
12/02	439.51	184.92	18.03	99.66	0.45	46.11
12/01	86.43	10.07	10.03	6.99	0.04	30.62
12/00	19.11	-14.69	0.0	-14.69	-0.22	0.0
12/99	0.22	-6.08	0.0	-6.08	-0.14	0.0

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2. Positive Earnings Growth Forecast Must Be Higher Than the S&P 500 Index & the Industry's Growth over the Next 3-5 years.

Ultimately, it is the market's belief in the company's future performance that drives its stock price up. When a stock is believed to be able to grow faster than the overall market (S&P 500) and all other stocks within its industry, it will attract lots of buyers and its share price

will escalate. From the 'Earnings Estimate' section, you can see that Google's (i.e. Company) earnings growth rate is forecasted to be +34.6% over the next 5 years. This is way above the growth rate of the S&P 500 (i.e. 8%) and the Industry (i.e. 26.8%).

Table 3: Earnings Growth Rates for Google

Screen capture from www.moneycentral.com

Earnings Growth Rates	Last 5 Years	FY 2006	FY 2007	Next 5 Years
Company	NA	+77.90%	+36.30%	+34.60%
Industry	+35.10%	+4.50%	+34.10%	+26.80%
S&P 500	+9.30%	+11.40%	+6.20%	+8.00%

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3. Stock Has A History Of 'Earnings Surprise'

An 'earnings surprise' is when a stock is able to beat analysts' earnings estimates. For example, analysts may estimate a company to achieve 'Earnings Per Share (EPS)' of $1.50 for the next quarter. If the actual EPS is $2, then there is an 'earnings surprise'. Earnings surprise is a strong determinant of stock price movement. From the table below, Google has beaten estimates for one out of four quarters. This is not bad.

Table 4: Earnings Surprise for Google

Screen capture from www.moneycentral.com

Earnings Surprise	(9/05)	(12/05)	(3/06)	(6/06)	(9/06)
Estimate	1.33	1.78	1.80	1.97	2.16
Actual	1.51	1.54	2.01	2.21	2.36
Difference	0.18	-0.24	0.21	0.24	0.20
% Change	+13.53%	-13.48%	+11.67%	+12.18%	+9.26%

Financial data in U.S. dollars

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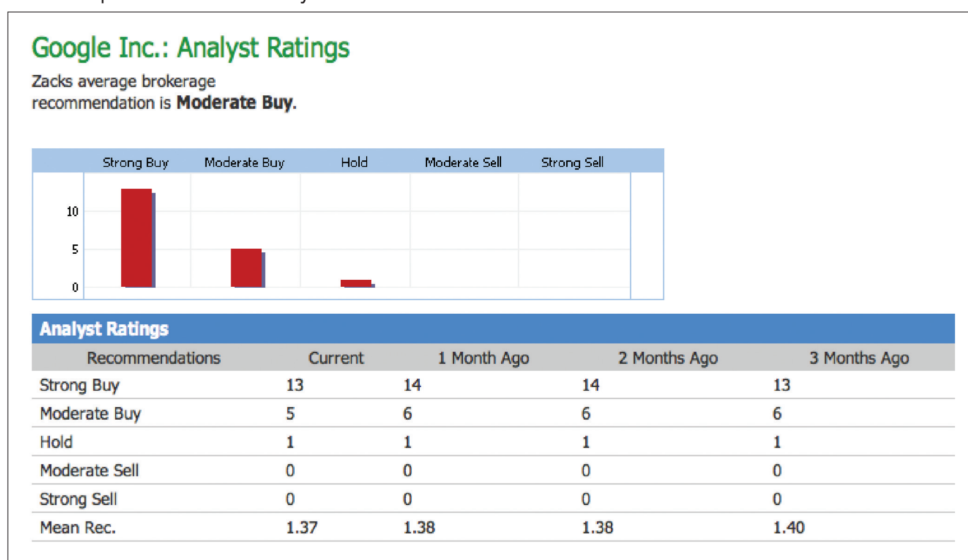
Finally, check out how analysts are rating the stock by clicking on 'Analysts Ratings'. This figure is important for momentum stocks as a 'strong buy rating' would signal more investors to buy the stock and raising the share price. As long as analysts rate a 'hold' or better, you can safely buy the stock. In this case, Google is rated 'Strong buy' by 13 analysts and 'moderate buy' from 5 analysts.

Table 5: Analysts Ratings for Google

Screen capture from www.moneycentral.com



Google Inc.: Analyst Ratings

Zacks average brokerage recommendation is **Moderate Buy**.

Analyst Ratings

Recommendations	Current	1 Month Ago	2 Months Ago	3 Months Ago
Strong Buy	13	14	14	13
Moderate Buy	5	6	6	6
Hold	1	1	1	1
Moderate Sell	0	0	0	0
Strong Sell	0	0	0	0
Mean Rec.	1.37	1.38	1.38	1.40

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Screen #3: Positive Insider & Institutional Ownership

The third criterion for a momentum stock is that insiders (people working in the company) and institutional investors should be accumulating the stock. If people working in the company, especially senior management are actively buying the stock, then it is likely that they expect the share price to rise.

Who would better know the company's prospects than the people working within? At the same time, if insiders are actively selling the stock, then it may signal a lousy investment. You can find this information on moneycentral.com as well, under the section 'insider trading'.

Table 6: Insider Trading For Google

Screen capture from www.moneycentral.com

Recent Insider Trading Activity: Google Inc.

Date	Name	Transaction	Num Shares	Price(s)	Value
12/27/06	HENNESSY JOHN L	Sold	230	$463.54	106,613.05
12/26/06	HENNESSY JOHN L	Sold	230	$457.10	105,131.85
12/22/06	SCHMIDT ERIC E	Sold	2,092	$453.42	948,565.13
12/22/06	SCHMIDT ERIC E	Sold	6,820	$456.20	3.11 Mil
12/22/06	SCHMIDT ERIC E	Sold	7,802	$455.62	3.55 Mil
12/22/06	SCHMIDT ERIC E	Sold	320	$456.20	145,982.41
12/22/06	SCHMIDT ERIC E	Sold	4,918	$454.45	2.24 Mil
12/22/06	SCHMIDT ERIC E	Sold	5,859	$454.04	2.66 Mil
12/22/06	SCHMIDT ERIC E	Sold	254	$454.97	115,562.38
12/22/06	SCHMIDT ERIC E	Sold	299	$457.58	136,817.92
12/22/06	SCHMIDT ERIC E	Sold	329	$456.68	150,249.36
12/22/06	SCHMIDT ERIC E	Sold	2,071	$457.58	947,658.56
12/22/06	SCHMIDT ERIC E	Sold	361	$455.62	164,478.81
12/22/06	SCHMIDT ERIC E	Sold	247	$454.45	112,247.91
12/22/06	SCHMIDT ERIC E	Sold	2,589	$455.62	1.18 Mil
12/22/06	SCHMIDT ERIC E	Sold	275	$454.01	124,852.75
12/22/06	SCHMIDT ERIC E	Sold	85	$453.42	38,540.70
12/22/06	SCHMIDT ERIC E	Sold	1,936	$454.04	879,021.44

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In Google's case, the CEO Eric Schmidt has sold over 244,080 shares worth $1.17 billion in the last three months. That represents 90% of his total holdings being sold. Now, if the CEO expected Google shares to continue rising soon, why would he sell all his shares? My common sense tells me that this is a red flag and a signal that I should not buy Google shares right now.

The next thing to look at is 'Institutional ownership'. This tells you if banks, financial institutions, pension funds and mutual funds are actively buying or selling the company's stock. It may be interesting to know that over 70% of a stock's trading activity comes from institutional investors. So when they are actively buying, there is a high chance the stock price will rise. You can find this out by going to www.moneycentral.com and click on 'Ownership'.

Table 7: Ownership Activity for Google

Screen capture from www.moneycentral.com

Google Inc.: Ownership

Ownership Information	
Shares Outstanding	306.00 Mil
Institutional Ownership (%)	57.80
Top 10 Institutions (%)	29.20
Mutual Fund Ownership (%)	30.11
5%/Insider Ownership (%)	28.44
Float (%)	71.57

Ownership Activity

Description	# of Holders	Shares
Total Positions	651	176,936,112
New Positions	71	5,731,269
Soldout Positions	63	-2,585,853
Net Position Change	157	5,140,457
Buyers	400	18,369,284
Sellers	243	-13,228,828

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We can see that there are slightly more institutions buying (400) than selling (243) Google shares. So in this case, does this criterion pass or fail? On one hand institutions are buying while insiders are selling. Well, you have to make up your own mind. As for me, I would pass and look for another momentum stock.

Screen #4: Strong Sales Growth & High ROE

Just like in evaluating value stocks, momentum stocks should also have a positive and increasing sales growth (also known as revenue) over the last 3–5 years. Return of Equity (ROE), which measures the company's profitability, should also be above 15%. Again, this information can be found in most financial websites. On moneycentral.com, just go to 'Key Ratios' and 'Financial Statement'.

Table 8: Key Ratios for Google

Screen capture from www.moneycentral.com

Investment Returns %	Company	Industry
Return On Equity	20.9	18.7
Return On Assets	19.2	16.3
Return On Capital	20.7	17.8
Return On Equity (5-Year Avg.)	NA	1.4
Return On Assets (5-Year Avg.)	NA	1.3
Return On Capital (5-Year Avg.)	NA	1.3

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Table 9: 10 Year Income Statement for Google

Screen capture from www.moneycentral.com

Income Statement | Balance Sheet | Cash Flow | 10 Year Summary

Annual   Interim

Financial data in U.S. Dollars
Values in Millions (Except for per share items)

	2005	2004	2003	2002	2001
Period End Date	12/31/2005	12/31/2004	12/31/2003	12/31/2002	12/31/2001
Period Length	12 Months	12 Months	12 Months	12 Months	12 Months
Stmt Source	10-K	10-K	PROSPECTUS	PROSPECTUS	PROSPECTUS
Stmt Source Date	03/16/2006	03/30/2005	08/18/2004	08/18/2004	08/18/2004
Stmt Update Type	Updated	Updated	Updated	Updated	Updated
Revenue	6,138.56	3,189.22	1,465.93	439.51	86.43
Total Revenue	**6,138.56**	**3,189.22**	**1,465.93**	**439.51**	**86.43**

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Checking the income statement affirms that sales (revenue) grew consistently from 2001 to 2005 at an accelerated rate. At the same time, Google has Return on Equity of 20.9, above the industry average of 18.7.

Screen #5: Bullish Market Sentiment

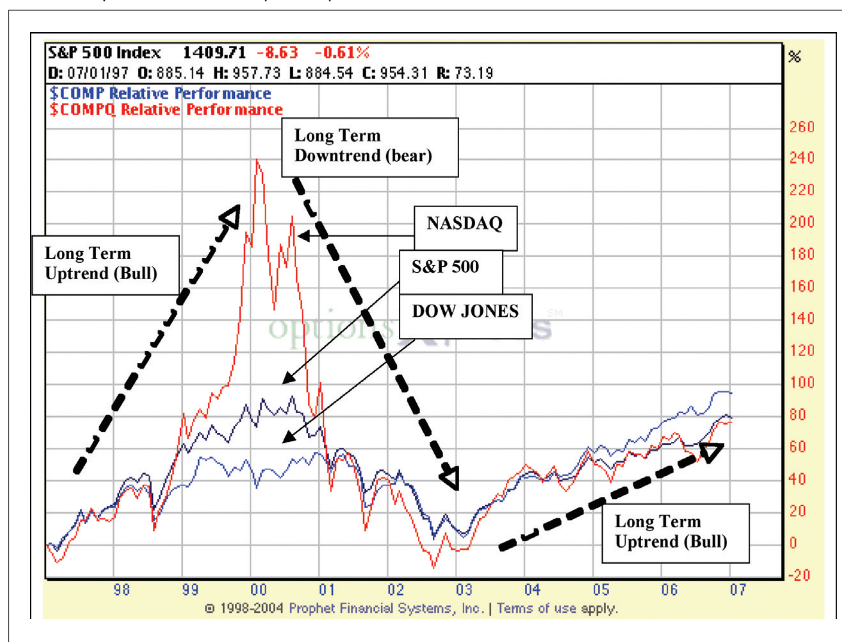
Prices of Momentum stocks are highly sensitive to the overall market sentiment. The market constantly goes through periods of optimism (known as a bullish market) and of pessimism (known as a bearish market).

When the market sentiment is overly bearish and fear causes widespread selling, the majority of stock prices will tumble down in price, regardless of how good the company is. At the same time, when the market sentiment is bullish, the expectation of rising prices causes widespread buying which in turn causes almost all stocks to increase in price.

It is in a bullish market that the best performing stocks making their strongest upward moves. Therefore, you should buy a momentum stock (even a value stock for that matter) only when the market sentiment is bullish. This can easily be confirmed by looking at the price charts of the three major indexes (Dow Jones Index, S&P 500, Nasdaq Composite index) that measure the health of the market.

Chart 7: Performance of Dow Jones, S&P500 & Nasdaq (10 Years)

Screen capture from www.optionsxpress.com



As you can see from chart 7, the three major indexes move very much in tandem. Over the last 10 years (1997-2006), it has gone through a long-term bull market (1997-early 2000) then into a three-year bear market (2000-end 2002) and finally into a 4-year bull

market (2003 to present). So, we are still in the midst of a long-term bull market.

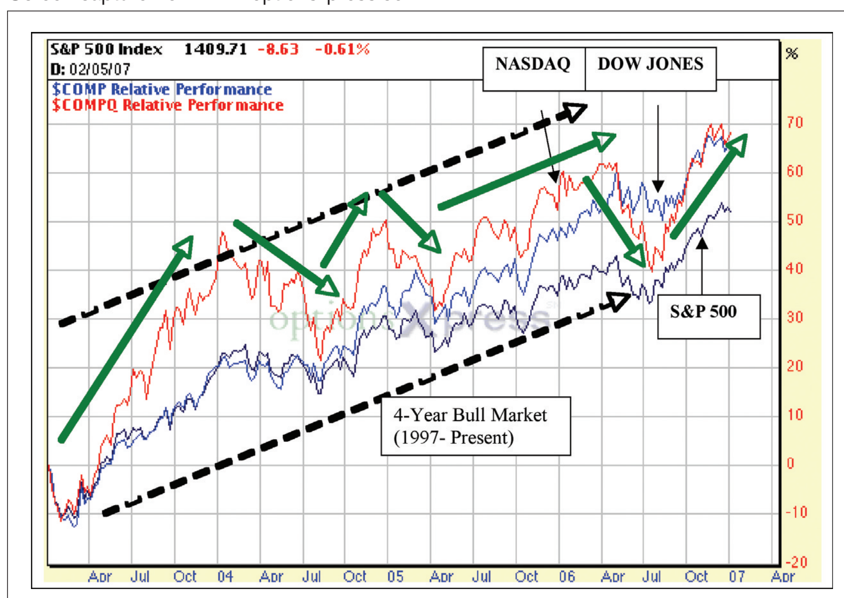
During a bearish market, all three indexes are in confirmed downtrend. You should definitely avoid buying any kind of stocks during this period because almost all stocks will keep falling continuously.

During a bullish market, all three indexes are in a confirmed uptrend. Although stock prices still move up and down, they keep getting higher with each upward move. So, does this mean that as long as we are in a long-term bull market, it is safe to buy momentum stocks? The answer is NO!

Remember from chapter 3, you learnt that within a long-term uptrend, the market can go into a short-term period of bearishness (3-4 months). Look at the next chart (i.e. chart 8). This time, we have zoomed in on the last 4-years of the long-term bull market (2003 to present).

Chart 8: Performance of Dow Jones, S&P 500 & Nasdaq (4 Years)

Screen capture from www.optionsxpress.com



You should only enter into a momentum stock when the market is in both a long-term and short-term bull market!

Screen #6: Stock is Near or At a Buy Point

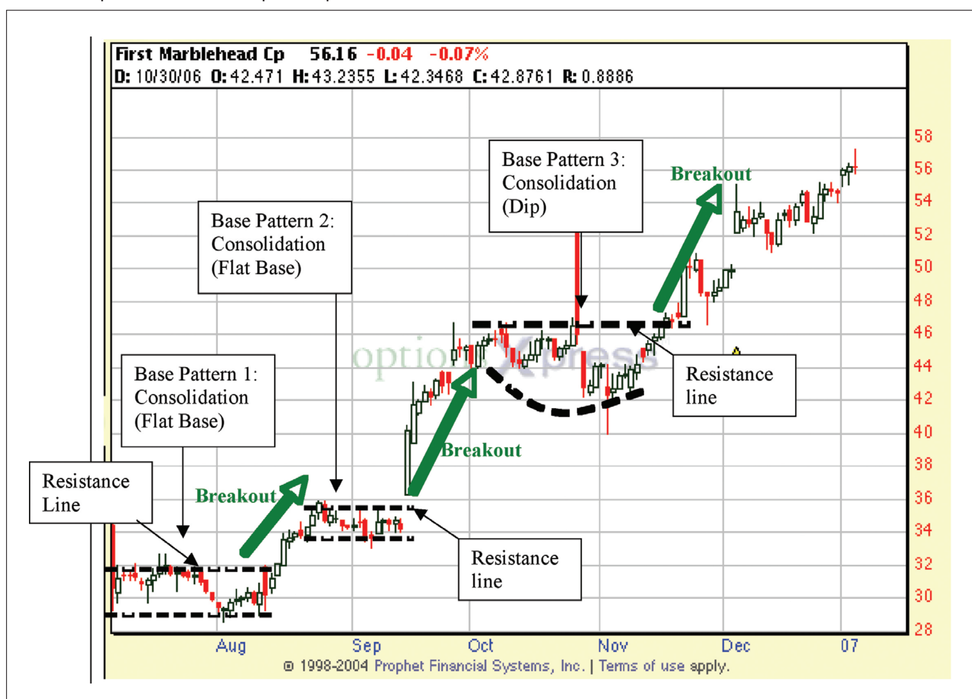
Remember that buying a momentum stock is all about timing. If you enter into the investment too early, the stock price will not move for a while or it may even move down further. If you enter too late, the stock price would have gone up so much (overbought) that it will come crashing down.

So, when is the best time to enter a trade? The answer is JUST BEFORE the stock is ready to make its major upward move. The next two screens (#6: stock near buy point and #7: positive technical indicators) will help you identify this moment.

So, when would an ideal buy point be? When would the stock be ready to move upwards? To answer this question, take a look at the price movement of a typical strong performing momentum stock (i.e. First Marblehead, Ticker Symbol: FMD).

Chart 9: Price Chart for First Marblehead: FMD

Screen capture from www.optionsxpress.com

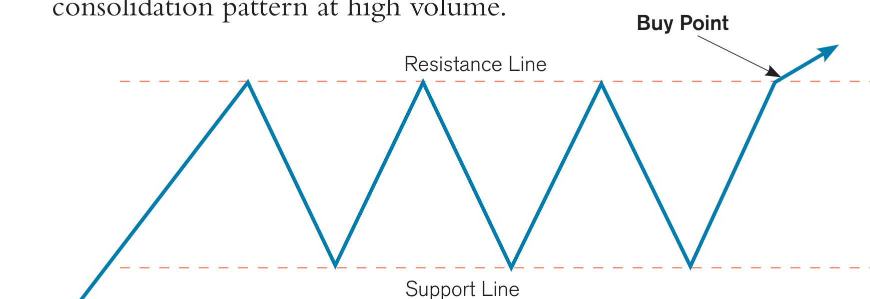


Notice that high performing stocks (i.e. FMD) go through periods of consolidation as they pause on their way to larger gains. A consolidation period is when the stock price moves sideways or even dips down before making its next upward move.

These consolidation patterns (also known as 'base patterns') are a healthy occurrence that is caused by profit taking or a temporary bearish market sentiment. Each consolidation period can last from 4 weeks to 6 months. Notice that FMD went through three consolidation patterns as it moved from $30 to $57.

During a consolidation pattern, the stock price usually moves up and down between two psychological lines: the support & resistance line. Every time the stock price hits the resistance line (like an imaginary ceiling), it will bounce back down again. As it moves down, it will hit the support line (like an imaginary floor) and bounce back up again.

So the stock bounces up and down and until one day it breaks through the resistance line at a high volume. The moment this happens, the stock will tend to move significantly upwards. This is the point at which you buy the stock. In other words, the buy point is when the stock price breaks above the resistance line and out of the consolidation pattern at high volume.



Sometimes, during a consolidation phase, the stock price may even take a dip of 30%–50%. This is known also as a correction and can be quite severe if the market sentiment is bearish.

An example of such a dip is shown in the stock price movement of US Global Investors (Ticker Symbol: GROW). From September to End October, it went into a consolidation pattern which is known as a 'Cup with Handle' pattern. Similarly, the best time to buy this stock would be when it breaks out of the pattern at high volume. So again, the buy point would be when prices move above the resistance line with high volume.

Chart 10: Price Movement of US Global Investors Inc (GROW)

Screen capture from www.optionsxpress.com

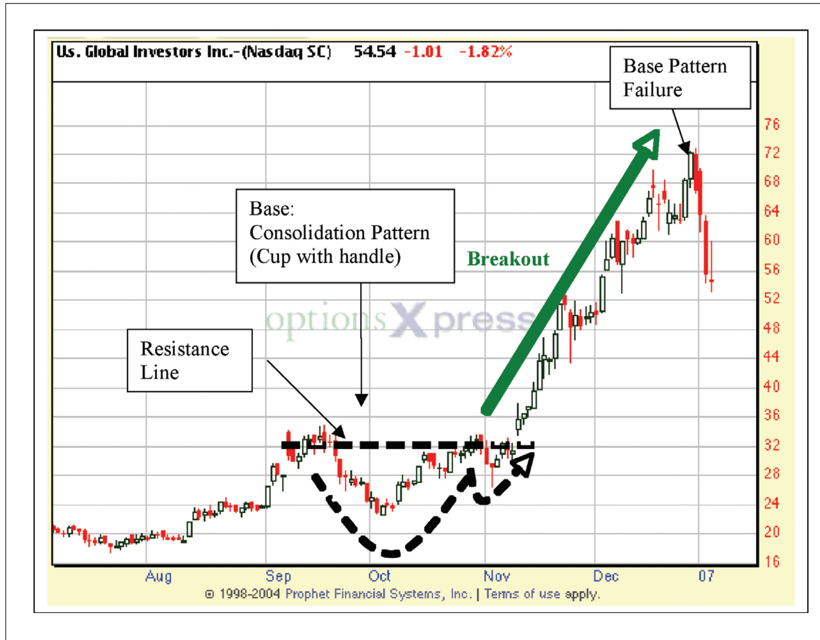
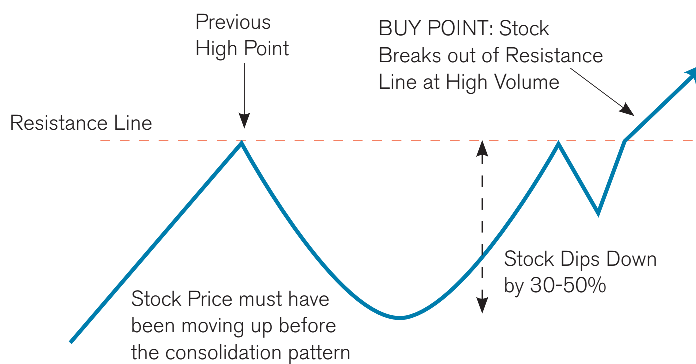


Chart 11: A Closer Look at How a Stock Breaks Out of a Cup with Handle Pattern.



**The resistance line is formed by the stocks previous high point. After the first dip, the stock should hit the old high point and move down for a second smaller dip. At its third attempt, the stock will break out of the pattern and move up.*

A Word of Caution

While all major stock price moves begin with a breakout from a consolidation pattern, NOT ALL breakouts from a consolidation pattern will be successful.

In fact, there are times when after a stock breaks out of the resistance line, it plunges down. Look again at Chart 10 and you will see that when GROW broke out of its second consolidation pattern, it started collapsing. This is known as a base pattern failure.

So, how do you avoid getting caught in such a scenario? Well there are certain things you must observe that could lead to a base failure.

The first is the volume of shares traded. Volume is represented by the vertical bars below the stock chart as explained in the earlier chapters. When the stock breaks out of the consolidation pattern, you should see a significant increase in volume (volume bar is higher than the average). This high volume shows that there is a lot of people beginning to buy the shares and this acts a confirmation of the stock's momentum.

If the stock price moves up while volume declines, then there will be a potential for the stock price collapsing thereafter. Take a look at the GROW chart once again in Chart 12 and you will see that the first two breakouts were successful because of a jump in volume (green bars). The third breakout failed because volume did not move up. Once the stock plunged, lots of people started selling the shares (shown in the red volume bars spiking up).

Chart 12: Stock Chart for US Global Investors (GROW) with Volume

Screen capture from www.optionsxpress.com

Another reason for a base failure is when the consolidation period is too short. Usually, the longer the consolidation period, the stronger the base and the greater likelihood will be of a successful breakout. A strong base is one that is at least 4-6 weeks long. As you can see, the third breakout failed because the dip was too short (about 2 weeks).

However if you want to be 90% sure that the breakout will be successful, you have to use Screen #7: 'Technical Indicators' (also known as technical studies) to give you the confirmation of a 'buy signal'.

Screen #7: Positive Technical Indicators

So what are 'Technical Indicators' and how can they confirm an entry into an investment? Technical indicators are a set of tools used to predict future price movements of a security by generating statistics from the analysis of past price patterns.

In other words, using advanced mathematical calculations, 'Technical Indicators' can give you signals of whether a stock is likely to move up (bullish) or move down (bearish). Although there are numerous indicators that professional investors use, what you really need are five of the most powerful ones. They are the:

1. 20-day & 50-day Simple Moving Average (SMA)
2. Moving Average Convergence Divergence (MACD)
3. Slow Stochastic
4. Relative Strength Reversal Index (RSI Reverse)
5. Parabolic SAR

I know it may all seem really complicated and confusing but you don't really need to know how they are calculated or what they really mean. All you have to know is how to use it to give you 'buy signal'. Although most people don't know exactly how electricity works, it does not stop them from switching on the lights, right? Let's look at them individually.

Indicator #1: 20-day & 50-day Simple Moving Average (SMA)

The most commonly used indicator is the Simple Moving Average (SMA). The SMA is basically the average stock price over a certain period of time and it is calculated by adding the closing price of the stock price for a number of time periods and then dividing this total by the number of time periods. For example, the 20-day SMA is calculated by adding the stock's closing price over the last 20-days and dividing the total by 20.

So, how can you use this to predict where the stock price is going? Well, whenever the stock's price crosses ABOVE a SMA line, it is an indication that the stock will continue to move up. So this implies a 'buy signal'.

Similarly, whenever the stock price crosses BELOW a SMA line, it indicates that the stock price will continue move down, signaling a 'sell signal'. Look at the example of Ceradyne Inc's (Ticker Symbol CRDN) stock movement in Chart 13 and see how powerful this indicator is!

Chart 13: Stock Price Of Ceradyne (CRDN)

Screen capture from www.optionsxpress.com

Notice that when the stock price crossed below the 20-day Moving average (red line), the stock price moved lower. When it crossed below the 50-day Moving average (blue line), it went even lower! However, in November, it suddenly crossed above both the 20-day and 50-day moving average, causing it to jump all the way up to $58!

At the same time, when a shorter term SMA (i.e. 20-day) crosses above a longer term SMA (i.e. 50-day), it is an even stronger indication of upward momentum. Notice that in November, the 20-day MA actually crossed over the 50-day MA, and when it did, the stock really started to fly!

To summarize, you can buy a stock when…

1. The stock price stays above the SMA or…
2. The stock price crosses above the SMA or…
3. A shorter term SMA (30-day) crosses above the longer term SMA (50 day)

Indicator #2: Moving Average Convergence Divergence (MACD)

If you think that the SMA is a powerful indicator as demonstrated earlier, then the MACD (moving average convergence divergence) is even more accurate as a momentum indicator. It is calculated by comparing two exponential moving averages (i.e.12-day and 26-day). The MACD indicator for Ceradyne stock chart is shown below.

Chart 14: MACD Indicator for Ceradyne (CRDN)

Screen capture from www.optionsxpress.com

So how do you use the MACD? Well, there are two things to look at:

1. When the two lines (blue & red) are above the '0-mark' (bullish area), it indicates upward momentum and a signal to buy. When the two lines are below the '0-mark' (bearish area), it indicates downward momentum and a signal to sell.

2. When the blue line crosses above the red line, it is a bullish signal to buy. When the blue line crosses below the red line, it is a bearish signal and an indication to sell. Look at the chart above and see how accurate this is at predicting the future stock price movement.

Indicator #3: Slow Stochastic Oscillator

The slow stochastic is another momentum indicator that compares the stock's closing price to its price range over a given time period.

Chart 15: Slow Stochastic Indicator for Ceradyne (CRDN)

Screen capture from www.optionsxpress.com

The way to read the slow stochastic is very much similar to the MACD except that the centre line is '50' and not '0'. The Slow Stochastic is also very much more sensitive to stock price movements as compared to the MACD. Again, there are two things to look at:

1. When the Blue Line moves above the '50-mark', it is considered a bullish signal and an indication to 'buy'. This is especially so when the lines come off the lower '20-mark' and reverses towards the '80-mark'.

Similarly, when the Blue Line moves downwards below the '50-mark', it is a bearish signal and an indication to 'sell'

2. When the blue line crosses above the red line, it is a bullish signal to buy. When the blue line crosses below the red line, it is a bearish signal and an indication to sell.

Indicator #4: Relative Strength Index Reversal Index (RSI Reverse)

This indicator is pretty simple to use. Basically, when the stock price is above the RSI Reverse line (i.e. blue line), it is a signal to buy. When the stock price is below the RSI Reverse line, it is a signal to sell.

Chart 16: RSI Reverse Indicator for Ceradyne (CRDN)

Screen capture from www.optionsxpress.com

Indicator #5: Parabolic SAR (Stop and Reversal)

This final indicator, known as the Parabolic SAR is also good at determining good exit and entry points. Basically, if the stock is trading above the parabolic SAR (i.e. blue dots) it is a good indication to buy. If the stock price is below the SAR (i.e. blue dot) then it is a signal to sell. Note that the dot may be a different colour from blue at times.

Chart 17: Parabolic SAR Indicator for Ceradyne (CRDN)

Screen capture from www.optionsxpress.com

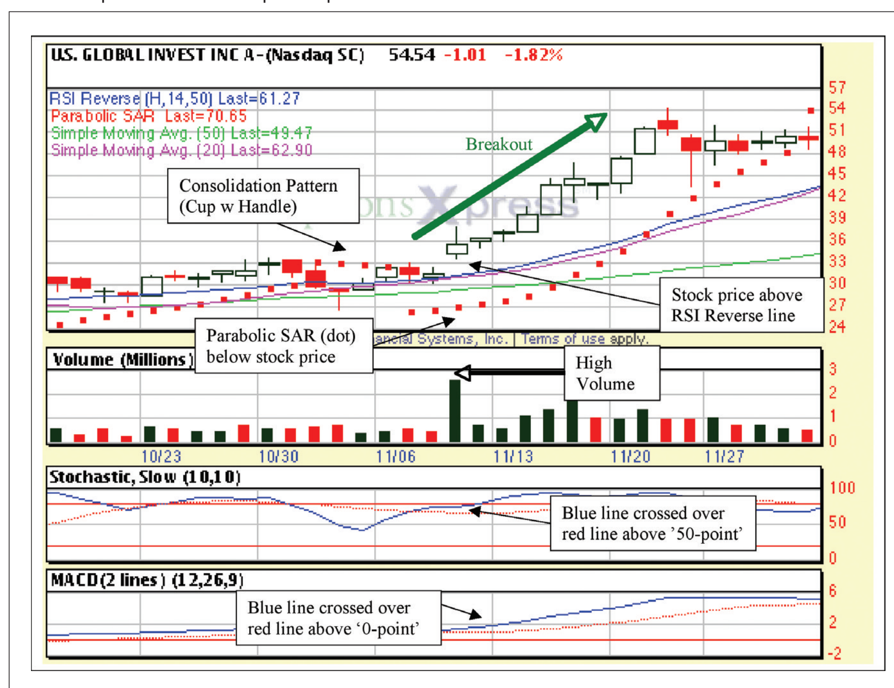
Putting it All Together: The Five Technical Indicators

Now that you have learnt five of the most powerful technical indicators, it is time to put it all together. It is very dangerous to use only one indicator to signal a 'buy signal' as each individual indicator is never 100% accurate.

If all five indicators signal a 'buy signal', then you can be over 90% sure that the stock will move up! (Given that your first 6 screens passed their criteria) Let's go back to the GROW example and see how everything ties in. As you can see below, when the stock price broke out of the consolidation pattern (cup with handle) at high volume, all five technical indicators were signaling a buy signal!

Chart 18: Five Technical Indicators for US Global Investors (GROW)

Screen capture from www.optionsxpress.com



When do I Sell to Minimize Losses and Maximize Profits?

Now that you know all the factors for buying a momentum stock, you have to know when to sell your position to minimize your losses and maximize your profits.

The most important thing to remember is that the market is so dynamic that anything can happen! You may find a great momentum

stock that meets all the seven screens. However, the moment you enter the trade, the company announces a product defect and recall. Suddenly, the stock price goes into a freefall! If you do not know when to sell your stock, you will suffer a major loss.

The important point I want to drive across to you is that no matter how good you are at evaluating a stock, the stock price WILL go against you at times! You will lose money at times!

In chapter 2 we learnt that even the best investors in the world like Warren Buffet and George Soros make wrong calls some of the time. However, even if you make three wrong picks out of six, you will still make profits if you learn how to cut your losing trades fast and know how to get the highest profits out of your winning trades.

Stop Loss: Protecting Yourself from Losses

One of the most common and important strategies used by investors is to place an automatic stop loss with their broker. This means that if the stock suddenly moves down in price to a certain level (known as the stop price), your broker will automatically sell your stock to minimize your losses.

As a rule of thumb, you can place a 'Stop Loss' 10% below your purchase price. So, the maximum you can lose if you are wrong is only 10%! So for example, if you bought CRDN shares at $46, then it would be wise to put an automatic stop loss of $41.40 on your shares. So, the moment the stock price drops and hits the $41.40 level, all your shares will be sold.

If you remember, I recommended a stop loss of 20% for value stocks. The reason the stop loss for momentum stocks is only 10% is because the latter tends to be a lot more volatile and can fall very much faster, given that they are usually overvalued.

Another strategy used especially by professional investors is to use the stock's price's previous low as the stop loss level. To find this price, you have to again study the stock charts. Let's look back at the example with GROW. In this case, the stop loss would be placed at the previous low point of $26.53 (red horizontal line)!

Chart 19: Placing a Stop Loss for GROW

Screen capture from www.optionsxpress.com

Stop Loss: Protecting Your Profits as Your Stock Flies!

Now, let's come to the exciting part. If you picked the right stock, the stock price should have broken out of the consolidation pattern and started to move up! The most common question is, 'when do I sell and take my profits?' By selling too early, you may miss out on even greater profits. However, if you wait too long, the price may suddenly reverse and wipe out the profits you have already made.'

Now, there is no way you can predict when the stock price is going to reach the top before reversing a downtrend, unless you use advanced technical strategies like 'Fibonacci Expansion' which is beyond the scope of this book (we only teach this at the Wealth Academy™ Investor Mentorship Programme).

So, it is very difficult to ever sell your stock at the highest price, however you can place a 'Trailing Stop Loss' order with your broker to protect and lock in your profits as the stock price goes higher and higher.

A 'Trailing Stop Loss' is a stop loss order that is set as a percentage (or dollar amount) below the market price of the stock. As such, the stop loss price is adjusted upwards as the stock price moves higher. For example, if you place a trailing stop loss of 10%, it means that the moment the stock price drops 10% below the last traded price, your stock (or option) will automatically be sold.

Finding Momentum Stocks

Now that you have learnt all the strategies for screening a momentum stock and know when to sell to take your highest profits, you may want to know where you can start looking for potential candidates to screen.

There are countless ways of finding momentum plays that are used by different investors. I will share with you some of the easiest methods you can start using.

1. Power Search on Moneycentral.com

Many financial research websites like www.moneycentral.com, www.morningstar.com and www.stockta.com have tools that will allow you to screen for stocks that meet both the fundamental and technical criteria that you are looking for.

For example, you can screen for all stocks that have an earnings growth rate of over 15% that have crossed over their 50-day moving average. The screening tool will then search its entire database of stocks (over 9,000), and list for you those that meet your criteria.

You can also use the 'Power Searches' tool on moneycentral.com which already has popular pre-selected criteria. I recommend that you start looking at stocks which come under 'Righteous Rockets', 'Great Expectations', 'Crossed above 50-day moving average' & 'Institutional ownership up last month'. For example, if you power searched for 'Righteous Rockets' on 9 Jan 2007, you would have five potential stocks to look at.

Table 10: Screen Capture from www.moneycentral.com

Power Searches

More Stock Searches

View: Righteous Rockets Go

Companies that appear undervalued, are profitable and have relatively low debt -- making them "righteous" -- but that are also fast growing and have begun to see significant stock price appreciation -- making them "rockets".

Righteous Rockets

Symbol	Company Name	Prev Day's Mkt Capitalization	Return on Equity	Price/Sales Ratio	Debt to Equity Ratio	Rev Growth Year vs Year
ATI	Allegheny Technologies Incorporated	8.659 Bil	53.46	1.95	0.45	29.50
BWLD	Buffalo Wild Wings	469.5 Mil	11.93	1.85	0.09	22.60
FSYS	Fuel Systems Solutions, Inc.	315.1 Mil	8.01	1.43	0.13	47.50
AZZ	AZZ Incorporated	296.4 Mil	15.49	1.41	0.16	22.80
USAP	Universal Stainless & Alloy Products	212.3 Mil	20.53	1.12	0.22	40.90

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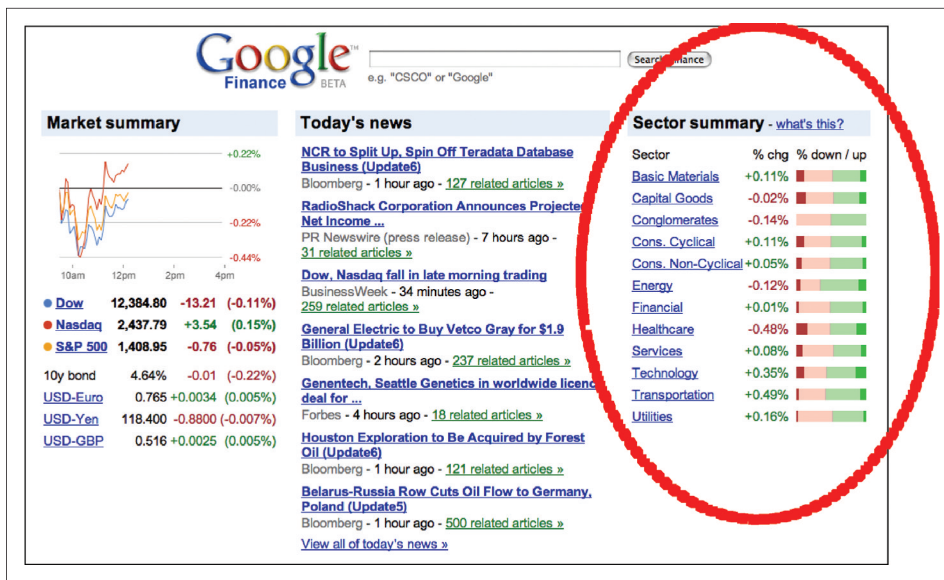
"Microsoft product screen shot(s) reprinted with permission from Microsoft Corporation."

2. Search from Top Down

Another strategy is known as the 'Top Down' approach in selecting stocks. You start off by looking at sectors & industries that are in rotation. Then, for potential 'hot sectors & industries'; look for stocks within them that have the highest price gains on high volume. Then put the stocks through the seven step screening process for momentum stocks. The moment the stock fails a particular criteria, take it off your potential buy list. However, if the stock happens to fulfill all the fundamental criteria (i.e. strong earnings growth, strong sales growth, positive institutional ownership) but is not at the 'buy point' or has poor technical indicators, then you can put it on your 'Watch List' until it is the opportune time to enter the investment.

You can start this selection process by going to http://finance.google.com and click on the different sector performances under 'sector summary'. The charts that come out will show you how each sector is performing compared to the S&P 500 Index (overall market). If the sector price line is moving much higher than the S&P 500, then it is a clear indication that the sector is a high performing one.

Table 11: Screen Capture from Google Finance



Google Finance images (c) Google Inc. Used with permission.

From table 12 on the next page, it appears that the "Technology Sector' has been outperforming the S&P 500 (broader market), especially in the last 5 days. In this case, you may want to take a look at the stocks within the Technology sector that have been making the highest gains under 'Top Movers' at the bottom of the screen. You can also go to www.moneycentral.com and check out the industries that are 'in favour' and the highest gaining stocks within those industries.

Table 12: Sector Performance Versus S&P 500 Index

Screen capture from Google Finance

Google Finance images (c) Google Inc. Used with permission.

3. Watch and Read the News Headlines Regularly

As a successful investor, you have to read the world news, business news and financial news every single day! It is a habit you should cultivate as the best investment ideas often come from the news that you get on financial news websites, business TV programs (like CNBC) and financial newspapers.

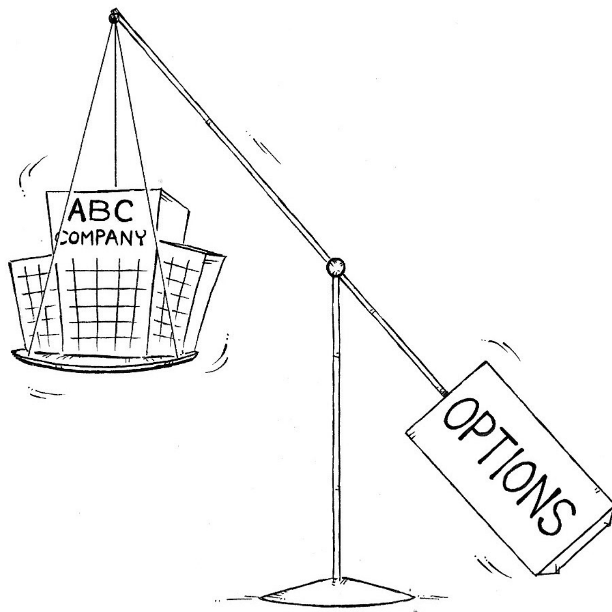
You will find both the general market news as well as company specific news very useful for finding great momentum stocks. For example, if there is news that oil prices are spiking up because of the war in the middle east, you will find that the stock prices of major oil companies (i.e. Exxon Mobil, Chevron Corp etc…) will start shooting up, making them great momentum plays.

You will often also hear news of companies that make the headlines for both the right reasons and the wrong reasons. For example, a company's stock may be frequently mentioned because they just developed a revolutionary product that will change the world and its stock price keeps moving up in very high volume. This is definitely the sign of a momentum stock that you can ride on. However, you would want to wait for a correction or consolidation to enter before the next run up in price.

Some of the news websites I suggest are www.cnbc.com, www.briefing.com and www.moneycentral.com. I read the news from these sites religiously at least four times a day. I also suggest you read newspapers like 'Wall Street Journal' and 'Investors Business Daily' regularly. You can get the digital versions of these papers from www.wsj.com and www.investors.com respectively.

The Amazing World of Options

6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chapter 6

The Amazing World of Options

Congratulations!

In the last few chapters you have learnt some of the most powerful strategies used by professional stock investors.

You have learnt how to select value stocks that return an average of 15–25% annually as well as momentum stocks that give huge returns over a much shorter period of time.

Is it possible to achieve even higher rates of return and at the same time lower our risk even further?

The answer is YES, and it can be achieved by using the power of Stock Options (which we will just refer to as 'Options').

Have you ever heard of Options trading? Most people, who have heard about options, would have been told that it is an extremely risky financial instrument.

Indeed, when I first heard about people trading options a couple of years ago, I immediately had a negative perception that it was a highly risky and speculative tool that was to be avoided by any serious investor.

However, when I first started to notice first hand how some of my friends were making huge monthly returns on their money with Options, I got really curious and decided to learn everything I could about this tool and make my own judgments!

Options can be Highly Risky… yet Highly Safe

So what did I discover?

Are options really that much riskier than trading in stocks? Well, yes and no. The truth is that for most people who are not trained properly in how to trade options, it can be EXTREMELY RISKY.

This is because when used inappropriately, you can lose 100% of your investment or a whole lot more within a short period of time. In fact, options can expose you to unlimited risks when traded in the wrong way.

This means that you could lose a lot more than your initial investment as compared to stocks where you can only lose whatever you have invested.

Investing in Options requires a lot more knowledge, skill and discipline as compared to investing in stocks alone. The reason why many people lose money in Options is because they lack the expertise in buying the right kind of stocks (i.e. value or momentum style) and are totally ignorant of the true value of the stocks on which the options are written.

This is the ultimate recipe for disaster. That is why I need to ensure that you have a really strong grounding in stocks, before I introduce to you the amazing world of Options.

The Power of Options… When Used Correctly

When you have a thorough understanding about Options and how they work, you can actually use Options to REDUCE RISK! Yes, that's right… reduce your risk (I thought I would say it again in case you thought it was a typo).

In fact, when used in the right way, Options can actually be less risky than stocks and at the same time, result in 5-10 X greater returns than buying stocks. In addition, Options allow you to make money no matter what direction a stock price takes. This means you can make profits when the stock price goes up, goes down and even if it moves sideways.

In this chapter and the one after, I am going to give you adequate knowledge to ensure that you know exactly how to use this powerful instrument in the correct way.

What is an Option?

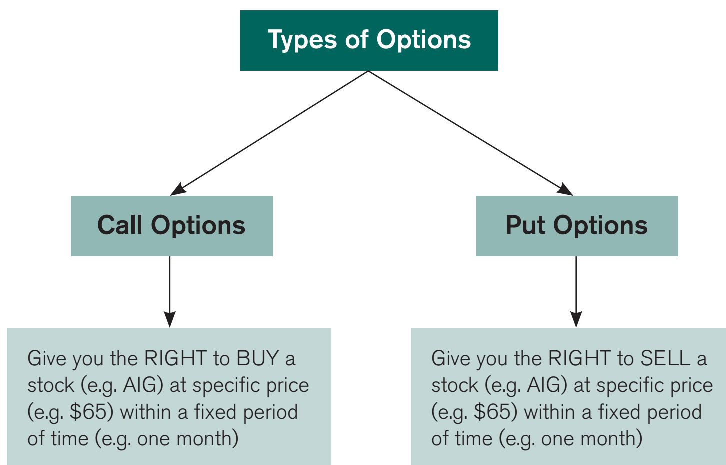
An option is a contract that is written on a specific asset like a house, a car or a stock. In the English language, an 'Option' is defined as the 'right to make a choice'. So an Options contract usually gives you the right to buy a specific asset at a pre-determined price.

For example, if you have an option to buy a car at a pre-determined price of $50,000, it means that you have the RIGHT to purchase the car at $50,000 within a specific time period. An option written on a particular house, means that you have the RIGHT to purchase that house at $1 million within a specific period of time.

Note that an Option gives you the RIGHT to purchase the asset and NOT the OBLIGATION. In other words, you can choose to exercise your right to purchase the asset within the time period or choose not to.

Similarly, when you have a 'Stock Option' written on a stock like American International Group (symbol: AIG), you have the right to buy AIG stock (usually in lots of 100 shares) at a specific price (e.g. $65) within a fixed period of time (e.g. one month). This type of stock option that gives you the right to buy a stock at a particular price is called a CALL OPTION. (i.e. you have the right to call the stock from someone).

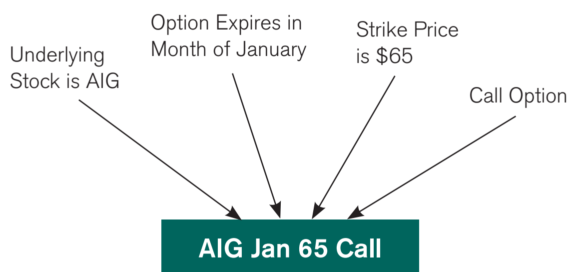
Another kind of Stock Option is known as a PUT OPTION. This type of option gives you the right to SELL a particular stock at a pre-determined price (e.g. $65). So if you have a PUT OPTION written on AIG stock, you have right to sell the AIG stock at $65 or choose not to. (i.e. you have the right to 'put' the stock to someone else). Let explore these two types of options in greater detail and how investors use them to make huge returns.



Basics of Call Options: The Right to Buy

A Call Option is basically a contract that gives you the RIGHT to BUY 100 shares of stock at a specific price (called the Strike Price) on/before an expiry date.

A Call Option is typically stated this way…



For example, if you buy an 'AIG January 65 Call' contract, it means that you now have the RIGHT to buy 100 shares of the AIG Shares at $65 on or before the third Friday of January (Options always expire on the third Friday of the expiry month).

So, no matter what happens to AIG's share price, you have the right to always buy it at $65! If AIG's shares price goes up to $100, you can still buy it at $65 (what a sweet deal). If AIG's share price goes to down $20, you can still buy it at $65 (although you probably would not be so unintelligent to do so). However, this special right only lasts until the expiration month stated (in this case, January).

Because it is a RIGHT, you can CHOOSE to buy the shares at $65 or CHOOSE not to. If you choose to buy the stock at $65, it means you have EXERCISED your option. If you choose not to, then you will let your options expire.

When Will You Exercise Your Right To Buy?

As a buyer of the AIG Jan 65 Call, when do you think you will exercise your RIGHT to buy AIG stock at the strike price of $65? Obviously, when the stock price INCREASES ABOVE this strike price.

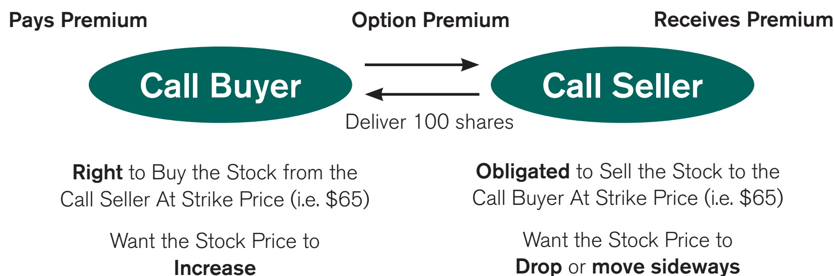
For example, if the AIG stock is currently trading at $70, then it makes sense to exercise the option and buy it at the strike price of $65. You can then sell your stock immediately at $70 for a $5 profit!

However, if the stock price is BELOW the $65 strike price, say at $55, it is then worthless to exercise the option. It is cheaper to buy the stock in the market at $55 than to exercise the option and buy it at $65.

To have this RIGHT to buy 100 shares at a particular price, the buyer of the Call Option will have to pay a price for it, called the Option Premium. For example, if the Option premium is $1.50, the Call Buyer would have to pay a minimum of $150 ($1.50 x 100 shares per contract).

For you to buy a Call Option, there must be someone who is selling a Call Option. So what happens when you are the SELLER of the Call Option? Well, the reverse happens. As a SELLER of the Call Option, you have the OBLIGATION to sell 100 shares of AIG stock to the Call Option Buyer at the strike price of $65 should the buyer exercise his right. So, why should the SELLER take on this OBLIGATION? Obviously for the premium paid by the Call Buyer to the Call Seller.

This is how the whole transaction will look like.



Buying Calls Allows You to Control Large Amounts of Stock

So when would you buy a Call Option?

Well, investors buy Call Options because they are BULLISH and expect the stock price to INCREASE. If you buy a Call Option with a strike price of $25, then you will want the stock price to increase as high as possible ABOVE $25.

For example, if the stock jumps to $35, then you would exercise your option and buy 100 shares of stock from the call option seller at $25. By buying stock at $25 and selling it immediately for $35, you

would make a $10 profit on each stock. Since one option contract is always 100 shares, your profit will be $10 x 100 = $1,000! If the Call Buyer paid $200 premium to buy the Call Options, then his net profit will be $1,000 – $200 = $800.

Options allow you to control a large quantity of stock with very little money! When you buy one Call Options contract, you are buying 100 Call Options that CONTROL 100 shares of the underlying stock. How does this compare to buying and owning the actual stock? Let's look at an example.

Buying Call Options Versus Buying Stocks

Let's say that AIG stock is currently trading at $65 (it is now January). From your value or momentum analysis, you expect the stock price to rise to $75 within six months. You can either buy AIG stock or buy the AIG Call Options.

Scenario 1: Buying AIG Stock

If you buy a 100 shares of stock, it will cost you $65 x 100 shares = $6,500. Your initial investment is thus $6,500.

If the stock price increases to $75, you can sell the stock and receive $75 x 100 shares = $7,500.

Your profit is $7,500 – $6,500 = $1,000

Your rate of return is $\frac{\text{Profit}}{\text{Investment}} = \frac{\$1{,}000}{\$6{,}500} = 15.4\%$

Scenario 2: Buying AIG Call Options

Since you expect AIG's price to increase to $75 in 6 months, you decide to buy one contract of July 65 Calls at a premium of $2. This contract will allow you to BUY 100 shares of AIG stock at $65 anytime before or on the third Friday of July.

Your cost = $2 x 100 shares = $200.

So, Your initial investment is now only $200.

If the stock price increases to $75, then you can potentially exercise your Call Option and buy the stock at $65 and sell it immediately for $75. So, each call option is worth at least $10 ($75 – $65)! The price of each option will thus increase to at least $10 in the market.

So, if you sell your 100 options, you receive \$10 x 100 = \$1,000. Your profit is \$1,000 – \$200 = \$800

$$\text{Your rate of return is } \frac{\text{Profit}}{\text{Investment}} = \frac{\$800}{\$200} = 400\%$$

As you can see, Options allow you to control 100 shares at a very low cost of investment and hence boost your rate of return dramatically. So what's the catch? The catch is that if the stock price does not move sufficiently above your strike price (i.e. \$65), then the option will expire worthless and you will lose your total investment of \$200.

Remember that the Option buyer has the right to buy and is not obligated to do so. If the stock price remains below the strike price (i.e. \$65); the Call Buyer would not exercise his option.

What About the Call Seller?

So, why would anybody sell a Call Option and take on this OBLIGATION to sell the shares at the strike price? Well, as the SELLER, you immediately receive the Option Premium (i.e. \$2 per option). Since one contract is always 100 share options, the SELLER will receive \$2 x 100 = \$200.

As a CALL SELLER, you are BEARISH and believe that the stock price will either not move or decrease. In both cases, the buyer who you sold the option to will not exercise his call option and you get to keep the Premium received for FREE.

Selling Calls Without Owning the Stock Exposes You to Unlimited Risk

What if the stock price does increase above the strike price? Then, as the SELLER, you are OBLIGATED to sell the 100 shares at the strike price as agreed. If you don't own the 100 shares, you will have to go into the market and buy the 100 shares at a much higher price and sell it to the call buyer. This is known as selling calls NAKED and is very risky. Why? Because your risk is unlimited! Let's say you sold the AIG July 65 Calls and collected \$200 in total premiums.

Suddenly, AIG shares increase to $100 and the Call Buyer exercises his call to buy 100 AIG shares from you at $65. You are now forced to buy 100 AIG shares at $100 ($100 x 100 shares = $10,000) and sell them to the Call Buyer for $65 ($65 x 100 shares = $6,500). You make a loss of $3,500 ($6,500 – $10,000).

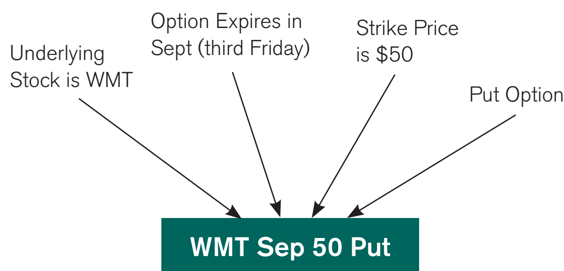
What if AIG shares went to $150? $200? As the Call Seller, your risk is Unlimited!

In the next section, I will show you how to Sell Calls in such a way that it actually puts extra money in your pocket and reduces your risk of holding shares of stock. In the meantime, let's understand the other type of Options known as Put Options.

Basics of Put Options: The Right to Sell

A Put Option is a contract that gives you the RIGHT to SELL 100 shares at a STRIKE PRICE on or before the EXPIRY DATE.

A Put Option is usually stated in the following way…



** WMT is the symbol for Wal-Mart shares*

For example, if you buy a 'WMT Sept 50 Put' contract, it means that you have the RIGHT to SELL 100 shares of WMT Shares at $50 on or before the third Friday of September. Because it is a RIGHT, you can CHOOSE to sell the shares at $50 or CHOOSE not to. If you choose to sell the stock at $50, it means you have EXERCISED your option. If you choose not to, then you will let your option expire.

(A common question that is always asked by beginners is whether you must first own the 100 WMT shares before buying & exercising a Put Option on it. The answer is NO. You can always sell the 100 WMT shares at a higher price (by borrowing it from the broker) and buying it from the market at a lower price to return the borrowed shares).

When Will You Exercise Your Right to Sell? When The Stock Price Decreases!

As a buyer of the WMT Sept 50 Put, when do you think you will exercise your RIGHT to sell WMT stock at the strike price of $50?

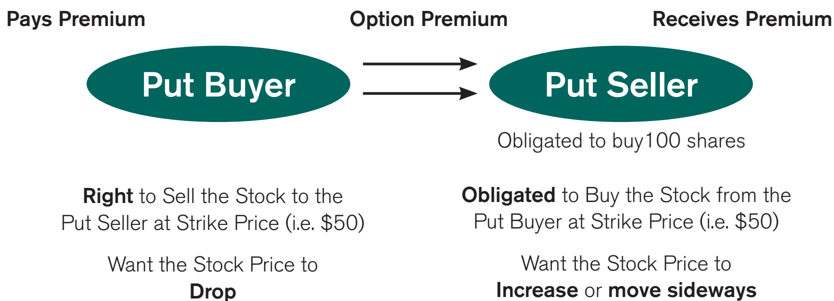
Obviously, when the stock price DROPS BELOW this strike price. For example, if WMT stock is currently trading at $40, then it makes sense to exercise the option and sell 100 shares at the strike price of $50. You can then buy WMT stock immediately from the market at $40 (to return to the broker) for a $10 profit! However, if WMT's stock price is ABOVE the $50 strike price, say at $55, it is then worthless to exercise the option.

To have this RIGHT to sell 100 shares at a particular price, the buyer of the put option will have to pay a price for it. Again, this is called the Option Premium. For example, if the Option premium is $2, the Put Buyer would have to pay a minimum of $200 ($2 x 100 options per contract).

For you to buy a Put Option, there must be someone who is selling a Put Option. So what happens when you are the SELLER of the Put Option? Well, the reverse happens. As a SELLER of the Put Option, you have the OBLIGATION to buy 100 shares of WMT stock from the Put Option Buyer at the strike price of $50 should the buyer exercise his right.

So, why should the SELLER take on this OBLIGATION? In return, the Put Option Seller will receive the Premium that is paid by the Put Buyer.

Here is how the transaction will look like.



When Would You Buy Put Options

Investors buy Put Options because they are BEARISH and expect the stock price to DECREASE.

If you buy a Put Option with a strike price of $50, then you will want the stock price to drop as low as possible BELOW $50.

For example, if the stock drops to $35, then you would exercise your option and sell 100 shares of stock to the Put option seller at $50. You can then go into the market and buy 100 shares at $35. By selling at $50 and buying back at $35 (Sell High, Buy Low), you make a profit of $15 on each share. Since one option contract is always 100 shares, your profit will be $15 x 100 = $1,500! If you had to pay $200 premium to buy the Put Options, then your net profit will be $1,500 – $200 = $1,300.

What About the Put Seller?

Why would anybody sell a Put Option and take on this OBLIGATION to buy the shares at the strike price? As the SELLER, you immediately receive the Option Premium (i.e. $2 per option). Since one contract is always 100 share options, the SELLER will receive $2 x 100 = $200.

As a PUT SELLER, you are BULLISH and believe that the stock price will either not move or increase. In both cases, the buyer who you sold the option to will not exercise his put option and you get to keep the Premium received for FREE. But what if the stock price does drop way below the strike price? Then, as the SELLER, you are OBLIGATED to buy the 100 shares at the strike price (i.e. $50) as agreed and sell them at whatever the market price is.

Selling Puts Exposes You to Unlimited Risk

For example, say you sell the WMT Sep 50 Put. You are obligated to buy 100 shares of WMT at the strike price of $50. Imagine if a scandal broke out and WMT shares plunged to $$30! The buyer, who you sold the Put Option to will exercise and sell you 100 shares at $50. So, you end up paying $50 x 100 = $5,000. You then have to sell these 100 shares at the market price of $30 ($30 x 100= $3,000) and suffer a $2,000 loss (–$5,000 + $3,000). What if WMT shares fell to zero? As you can see, selling Put Options exposes you to unlimited risks.

Option Buyers Have the Right, Option Sellers Have the Obligation

In both Call and Put Options, you can see that as an Option BUYER, you have the RIGHT (but not the obligation) to exercise your option. As a BUYER, your risk is only limited to the premium you paid.

As an Options Seller, you are OBLIGED to buy or sell the shares whenever the buyer exercises his RIGHT. This exposes you to unlimited loss and risk. Does this mean we should never be a seller? You will see later on that there are ways to limit your risks as a seller and in fact make huge returns from it.

Options Buyers Have the Right – Limited Risk
Option Sellers Have the Obligation – Unlimited Risk

Call Options In The Money, At The Money & Out of the Money

In trading Options, you must know when your option becomes very valuable and starts making you lots of money. The value of your option depends on whether the strike price (the price which you have the right to buy 100 shares at) is 'in the money' or 'out of the money'.

What does this mean? Well, consider the following five WMT Jan Calls that have strike prices of $45, $50, $55, $60 and $65 respectively. Which Calls do you think will be more valuable?

	WMT Calls	Call Intrinsic Value	
	Jan 65 Call	Out of the Money	$0
	Jan 60 Call	Out of the Money	$0
WMT@$55 →	Jan 55 Call	At The Money	$0
	Jan 50 Call	In The Money	$5
	Jan 45 Calls	In the Money	$10

If WMT is currently trading at $55, then the Jan 45 Call would have an intrinsic value of $10.

Why? Because if you held the Jan 45 Call, you have the right to exercise the option and buy WMT shares at $45. You could sell it at $55 and make an immediate $10 profit.

Thus, the Jan 45 Call is worth at least $10. This is known as the Option's intrinsic value. And this call is considered to be IN THE MONEY (ITM).

An IN THE MONEY Call Option basically means that the Option Strike Price is below the current share price. The intrinsic value of a Call Option = Stock Price – Strike Price

Intrinsic Value Call Option = Stock Price – Strike Price

Similarly, the Jan 50 Call is IN THE MONEY and has an intrinsic value of $5.

How about the Jan 55 Call? The Jan 55 Call is considered; AT THE MONEY. A call whose strike price is equal to stock price is; AT THE MONEY (ATM). ATM Calls have zero intrinsic value.

All calls with strike prices above $55 are Out of the Money (OTM) and have zero intrinsic value. For example, if you had the Jan 60 Call, there would be no point in exercising the option and buying WMT stock at $60, since you can buy it cheaper at the market rate of $55. So the Jan 60 Call has no intrinsic value and is 'Out of the Money'.

Put Options in the Money, at the Money & Out of the Money

How about Put Options? The opposite holds true. In the diagram below, consider the following five WMT Jan Puts that have strike prices of $45, $50, $55, $60 and $65 respectively.

Which Calls do you think will be more valuable?

WMT Calls	Call Intrinsic Value	
Jan 65 Put	In the Money	$10
Jan 60 Put	In The Money	$5
Jan 55 Put	At The Money	$0
Jan 50 Put	Out of the Money	$0
Jan 45 Put	Out of the Money	$0

WMT@$55 → Jan 55 Put

If WMT shares are currently trading at $55, then the Jan 65 Put would have an intrinsic value of $10. Why? Because if you held the Jan 65 Put, you have the right to exercise the option and sell WMT shares at $65. By buying it at the market price of $55 and selling it at $65, you make an immediate $10 profit.

Thus, the Jan 65 Put is worth at least $10. This is known as the Put Option's intrinsic value. And this Put is considered to be IN THE MONEY (ITM). An IN THE MONEY Put Option basically means that the Option Strike Price is ABOVE the current share price. The intrinsic value of a Put Option = Strike Price – Stock Price

Intrinsic Value Put Option = Strike Price – Stock Price

Similarly, the Jan 60 Put is IN THE MONEY and has an intrinsic value of $5. Again, the Jan 55 Put is AT THE MONEY.

A Put whose strike price is equal to the stock price is AT THE MONEY (ATM). ATM Puts have zero intrinsic value. All Puts with strike prices below $55 are Out of the Money (OTM) and have zero intrinsic value.

For example, if you held the Jan 45 Put, then there would be no point to exercise your option and sell WMT shares at $45 since WMT shares are trading at $55. So, this Jan 45 Put has no intrinsic value and is 'Out of the Money'.

What Determines Option Prices (Premium)

What determines the price you have to pay for the Option? And once you buy an option, what would make its price increase so you can sell it for a profit?

You may be surprised to know that Option Buyers DO NOT exercise their options 90% of the time, even when it is in the money! Why? Because, most call option buyers are not interested in actually buying the stock (they have to come up with the capital) and most put option buyers are not interested in selling any stock since they don't own the stock in the first place!

Instead, Option buyers often make their profits by selling their options once it has increased in price! So, let's find out what determines an options price! What gives an option its value?

From the last section, we talked about the Intrinsic Value of a Call and a Put. Intrinsic value is how much the Call or the Put is 'In The Money'. Again, recall that for a Call Option, the Intrinsic value = Stock Price – Strike Price.

Intrinsic Value of Call = Stock Price – Strike Price

Does this mean that Calls that are 'At the Money' or 'Out of the Money' are worthless? Of course not! Although ATM and OTM calls have zero intrinsic value, they are still worth something.

Why? Because if there are 30 days to expiration, then there is still a chance that the stock price could move 'into the money'. This value is called the Option's TIME VALUE. If an option still has 270 days to expiration, there is an EVEN BIGGER chance that the stock will move into the money.

So, the longer the time to expiration, the higher the TIME VALUE of the Option. Therefore, an Option's Premium is made up of its INTRINSIC VALUE and its TIME VALUE.

Option Premium = Intrinsic Value + Time Value

Options Premium

=

Intrinsic Value + Time Value

Intrinsic Value	Time Value
Calls: Stock Price – Strike Price Puts: Strike Price – Stock Price	Decreases until it reaches zero at expiration

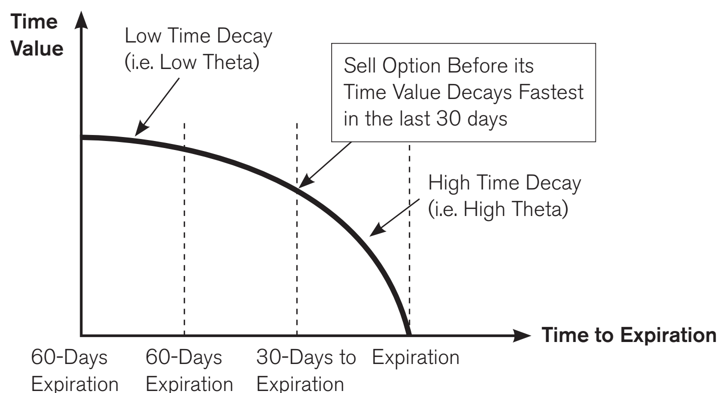
For example, TYC shares (Tyco International) is currently trading at $28 in January. How much should the TYC March 25 Calls be worth? Well, the Intrinsic Value of the calls would be $3 ($28 – $25).

So, the Call premium must be more than $3 as there is still 90 days to go and there is still a lot of time for the option to move even further into the money. So, if the Calls are priced at $3.30, it means that the Time Value of the March 25 Calls is $0.30. In other words…

Time Value = Option Premium – Intrinsic Value

Theta: The Decay of Time Value

As times passes and an Option moves towards its expiration date, its 'Time Value' will decreases until it reaches ZERO. As the expiration date draws nearer, the option will lose its value (i.e. Time Value) at an accelerated rate. As you can see from the graph below, time value decays the fastest during the last 30 days before the expiration date (always the third Friday of the month). This is why you should always buy an option that has more than 60 days to expiration. In this way, the time decay is minimal.



Lesson: Buy Options That Have A Longer Time To Expiration!

By buying Options that have a longer time to expiration, you will have more time to be right. However, these Options would obviously be more expensive as they have greater Time Value.

Options with the longest time to expiration are called LEAPS (Long Term Anticipation Securities), which have expiration dates over 9 months, usually 1–3 years even.

Because an Option's Time Value decreases the fastest in the last 30 days, it is always good to SELL YOUR OPTION 30 days before the expiration date. This way, you get a higher price for it since there is still BOTH Time Value and Intrinsic Value left.

Always Sell Options 30 Days Before Expiration

At Expiration, the Time Value is Zero and the Option Premium will only be made up of the Intrinsic value. So, if your Option is still 'Out of the Money' by the expiration date, then your option will be worthless!

So how fast does an option lose its time value? This is measured by 'Theta'. For example if the Theta of an Option is \$0.005. It means that the Option's Time Value is dropping by \$0.005 every day. As the Option approaches expiration, the Theta starts to increases dramatically!

Reading a Stock's Option Chain

So, how do you go about finding all the different Call and Put Options that are available on a particular stock? Just go to your online broker's website (e.g. www.optionsxpress.com), type in the stock's name or symbol (i.e. AIG) and click on 'chains'. You will then be presented with the stock's OPTION CHAIN as shown below.

Chart 1: AIG Option Chain

Screen capture from www.optionsxpress.com

Calls									Puts							
Symbol	Last	Chg	Bid	Ask	Vol	OpInt		Strike	Symbol	Last	Chg	Bid	Ask	Vol	OpInt	
Nov 06 Calls			(25 days to expiration)					AIG @ 66.74							Nov 06 Puts	
AIGKL	6.80	+0.10	6.90	7.10	22	7,481	trade	60.00	AIGWL	0.05	-0.05	0	0.05	18	28,769	trade
AIGKM	2.30	+0.05	2.30	2.40	538	69,499	trade	65.00	AIGWM	0.40	-0.10	0.35	0.40	122	22,575	trade
AIGKN	0.15	0	0.15	0.20	183	16,526	trade	70.00	AIGWN	3.20	-0.40	3.20	3.40	22	1,219	trade
AIGKO	0.05	0	0	0.05	0	3,077	trade	75.00	AIGWO	8.70	0	8.20	8.40	0	73	trade
Dec 06 Calls			(53 days to expiration)					AIG @ 66.74							Dec 06 Puts	
AIGLL	0	0	7.10	7.20	0	0	trade	60.00	AIGXL	0.10	0	0.05	0.15	10	0	trade
AIGLM	2.65	0	2.70	2.85	112	0	trade	65.00	AIGXM	0.70	0	0.65	0.75	167	0	trade
AIGLN	0.35	0	0.35	0.45	5	0	trade	70.00	AIGXN	3.70	0	3.30	3.50	32	0	trade
AIGLO	0	0	0	0.05	0	0	trade	75.00	AIGXO	0	0	8.20	8.40	0	0	trade
Jan 07 Calls			(88 days to expiration)					AIG @ 66.74							Jan 07 Puts	
AIGAL	7.00	-0.20	7.50	7.70	3	18,296	trade	60.00	AIGML	0.25	-0.05	0.20	0.25	50	36,223	trade
AIGAM	3.10	0	3.20	3.40	225	66,994	trade	65.00	AIGMM	1.10	0	0.90	0.95	9	35,582	trade
AIGAN	0.68	+0.03	0.70	0.75	1,223	28,193	trade	70.00	AIGMN	3.50	-0.40	3.40	3.60	146	4,278	trade
AIGAO	0.10	+0.01	0.05	0.10	21	18,945	trade	75.00	AIGMO	8.75	0	8.20	8.40	0	13	trade

Chart 1 shows all the Options that expire in Nov 06, Dec 06 and Jan 07. As you can see, all the Strike Prices are presented at the centre and all the Calls are listed on the left and the Puts on the right. In Chart 2, I have zoomed in on the 'Call Options' section.

Chart 2: AIG Call Option Chain

Screen capture from www.optionsxpress.com

Calls									
Symbol	Last	Chg	Bid	Ask	Vol	OpInt		Strike	Symb
Nov 06 Calls			(25 days to expiration)					AIG @ 66.74	
AIGKL	6.80	+0.10	6.90	7.10	22	7,481	trade	60.00	AIGW
AIGKM	2.30	+0.05	2.30	2.40	538	69,499	trade	65.00	AIGW
AIGKN	0.15	0	0.15	0.20	183	16,526	trade	70.00	AIGW
AIGKO	0.05	0	0	0.05	0	3,077	trade	75.00	AIGW
Dec 06 Calls			(53 days to expiration)					AIG @ 66.74	
AIGLL	0	0	7.10	7.20	0	0	trade	60.00	AIGX
AIGLM	2.65	0	2.70	2.85	112	0	trade	65.00	AIGXI
AIGLN	0.35	0	0.35	0.45	5	0	trade	70.00	AIGX
AIGLO	0	0	0	0.05	0	0	trade	75.00	AIGX
Jan 07 Calls			(88 days to expiration)					AIG @ 66.74	
AIGAL	7.00	-0.20	7.50	7.70	3	18,296	trade	60.00	AIGM
AIGAM	3.10	0	3.20	3.40	225	66,994	trade	65.00	AIGM
AIGAN	0.68	+0.03	0.70	0.75	1,223	28,193	trade	70.00	AIGM
AIGAO	0.10	+0.01	0.05	0.10	21	18,945	trade	75.00	AIGM

The Call Option Chain shows you the different Calls that are available at the different Strike Prices and at different months to expiration. For example, for Call Options Expiring in Nov 06, there are five Calls namely:

1. AIGKL: Strike price 60, last traded price $6.80 (AIG Nov 60 Call)
2. AIGKM: Strike price 65, last traded price $2.30 (AIG Nov 65 Call)
3. AIGKN: Strike price 70, last traded price $0.15 (AIG Nov 70 Call)
4. AIGKO: Strike price 75, last traded price $0.05 (AIG Nov 75 Call)

Since AIG's stock price is currently at $66.74 (AIG@$66.74), then AIGKL and AIGKM are 'In the Money' while AIGKN and AIGKO are 'Out of the Money'.

Usually, ITM options are shaded in 'Yellow' and are much more expensive. So, if you wanted to buy the AIG Nov 60 Call (symbol AIGKL) what price do you pay (i.e. Option Premium)? Well, you would look at the 'ASK COLUMN' and see that the market is willing to sell it at $7.10. So, this is the price you would pay if you wanted to buy it now.

If you wanted to sell the AIG Nov 60 Call (symbol AIGKL), then look at the 'BID COLUMN'. This shows how much the market is willing to buy this Call at. In this case, it is $6.90. So, you can sell your Call option at $6.90.

Note that at the same strike price, the December Options cost more than the November Options. And the January Options cost more than the December Options. This makes sense as Options with further expiration dates have more time value. You can also see that the further the Option is IN THE MONEY, the more expensive it is.

In summary, the Option Chain shows you the following information…

Last: This tells you the last price this option traded at.

Chg: This shows how much the price has changed since the last trade.

Bid: This shows how much the market is willing to BUY this option at
=> If you want to SELL your option, this is the price you can sell at currently.

Ask: This shows how much the market is willing to SELL
=> If you want to BUY this option, this is the price you can buy at currently

Vol: This shows you how many options are traded on this day.

Opint: Open Interest indicates the number of options that are open & have not been sold or exercised. This is a measure of the liquidity of the particular option. Before trading an Option, ensure that the Open Interest is sufficiently high.

How Stock Volatility Affects Your Option Price

Another major factor that affects the price of an option is the VOLATILITY of the stock at that particular point in time. The higher the volatility of the stock, the more expensive the Option Premium will be.

For example if a stock like Pfizer (Ticker Symbol: PFE) is currently trading between $17 and $20, then the volatility is relatively low. As a result, the Call & Put Options will be much cheaper. Why? Because if the stock does not move much, then it is more unlikely that the Puts or Calls will move 'Into the Money'.

However, if PFE suddenly becomes very volatile and swings between a high of $50 and a low of $5, the volatility will be very high! Options on this stock will be high.

'VEGA' is a term that measures the impact of a stock's volatility on the price of the option. A VEGA of 0.20 means that for every 1% increase in volatility, the option will increase by $0.20.

So why is this important? Well, the lesson is to buy Options while the volatility is still low (Option is cheap). However, you are expecting an increase/decrease in the stock price soon that will make the options more valuable.

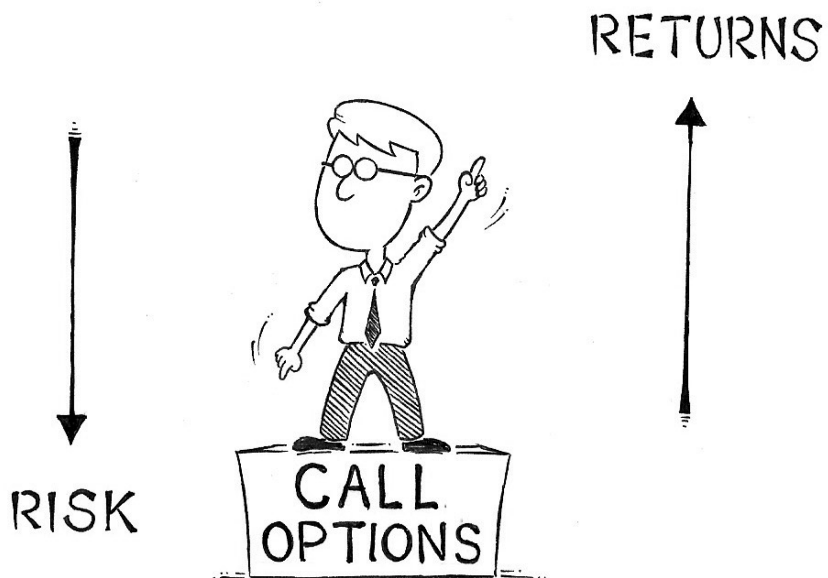
Volatility Low ⟶ Options Cheap ⟶ Buy Options

Volatility High ⟶ Options Expensive ⟶ Sell Options

With that, you have almost covers all the basics that you need to know about Options. Once you understand the basics of Call & Put Options, it is time to see how we can apply this powerful instrument that will help us build our net worth!

7

Using Call Options to Reduce Risk & Boost Returns


RETURNS
RISK
CALL
OPTIONS

chapter

7

Using Call Options to Reduce Risk & Boost Returns

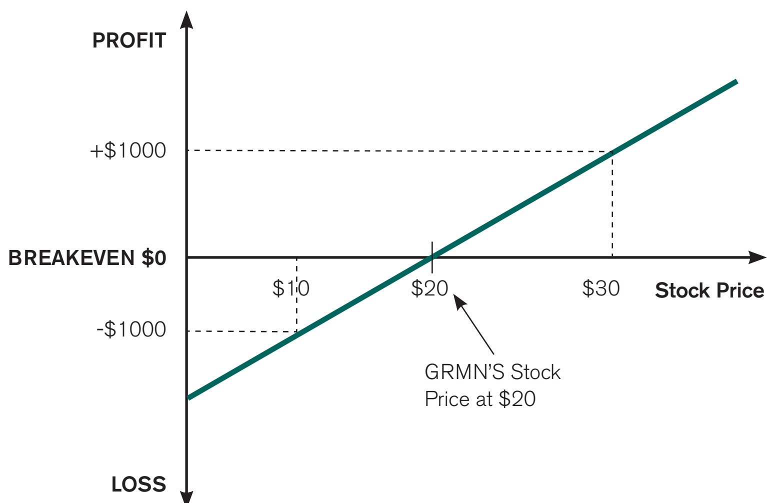
Now that you are familiar with the basics of how options work, let's discover how we can use this powerful tool to reduce our risks and boost our returns in stocks that we believe will increase in value (bullish).

Strategy 1: Buying Calls to Boost Returns by 100%-200%

First let's compare the difference between buying a stock and buying Call Options on the stock. For example, through your momentum research, you find that Garmin Ltd (Ticker Symbol: GRMN) (currently trading at $20) is likely to increase to at least $24.

If you buy the 100 shares of GRMN stock at $20, the risk-return graph will looks like this…

Chart 1: Risk Return Graph for a Stock Buyer i.e. Buying 100 Shares of GRMN Stock

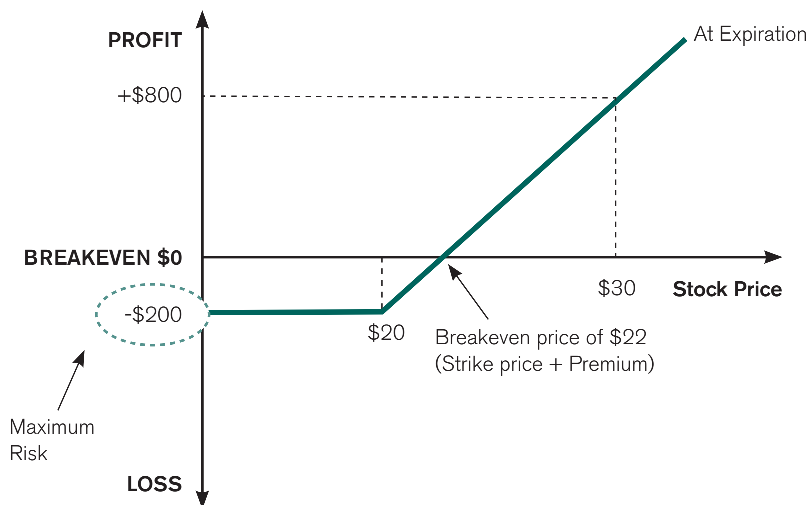


The horizontal axis shows the different prices of the stock and the vertical axis of the graph shows the profit & loss you will make at varying stock prices.

From the Chart 1 above, you can see that by buying the stock, you have unlimited return and limited risk. When the stock price increases by $10 to $30, your profit is $1000 (i.e. $10 profit x 100 shares). If the stock drops by $10 to $10, you lose $1000 (i.e. –$10 loss x 100 shares). So, for every $1 of increase/decrease in stock price, your profit/loss will increase/decrease by $1. Since you bought 100 shares, your profit/loss will multiply by 100.

What if you bought the GRMN Jan 20 Call Option instead? By checking the Option Chain, you find that the option's price is $2. If you buy one contract (100 options), so your initial investment will be = $2 x 100 = $200. This is what the risk-return graph will looks like.

Chart 2: Risk Return Graph for a Call Option Buyer i.e. Buy 1 Contract of GRMN Call Options



Remember that as the buyer of a Call Option, you have the RIGHT to buy 100 shares of GRMN at the strike price of $20. You will only do so if the stock price increased way beyond your $20 strike and your Option became 'In the Money'.

If the stock price did not move or decreased instead, you would not exercise your option and at expiration, it will become worthless. In this case, you would lose your investment of $200 which you used to buy the Calls.

In Chart 2 you can see that your risk is only limited to the premium you paid for the option contract (i.e. $200). So, no matter how much the stock may drop, your maximum loss is always $200.

If the stock price does not move, you also stand to lose your $200. So in a way, buying the Calls is actually less risky (i.e. you can only lose $200) than buying 100 shares of the actual stock (i.e. you can lose $2,000 if the GRMN drops to zero).

On the other hand, you enjoy unlimited upside potential! If the stock price increases by $10 to $30, you get a profit of $800! The higher the stock moves, the more you earn.

How do you get $800? Well, remember that you own the right to buy the stock at $20. So if the stock goes to $30, you can sell it for a $10 profit per share ($30 – $20). Since you control 100 shares, your profit is $10 x 100 = $1000. After deducting the $200 which you paid to buy the Options contract, your actual NET profit is $1000 – $200 = $800.

Since you paid a premium of $2 per option, the stock MUST move $2 above the strike price of $20 BEFORE you can make a profit! Therefore, the breakeven point is $20 + $2 = $22!

To summarize,
Your Maximum risk (loss) = Option Premium paid
(i.e. $2 x 100 shares = $200)

Your Profit = Stock Price – Strike Price – Option Premium
i.e. ($30 – $20 – $2) x 100 = $800

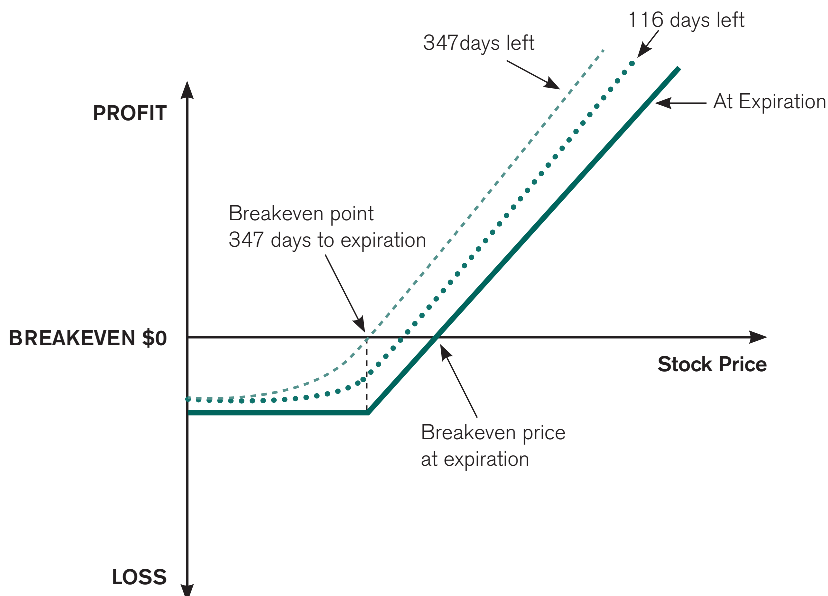
Breakeven Point = Strike Price + Option Premium
(i.e. $20 + $2 = $22)

Risk-Return Graph at Different Points in Time

Note that the Risk-return Graph of a Call Buyer shown above (Chart 2) is only at the point of expiration (when time value becomes zero). In reality, you will normally sell your option before expiration (at least 30 days before), so your option will also have the additional time value!

So, the return you get could be potentially higher than just the intrinsic value of the Call. An example of a Risk-Return graph at different points in time is shown below.

Chart 3: Risk Return Graph for a Call Buyer at Times to Expiration



You can see that when you buy a Call Option that has many days to expiration, with lots of time value, the value of the Option is much higher and the breakeven point is much lower. This is why it is always a good idea to sell your Options way before the expiration date.

How Buying Calls Boosts Your Returns to 100-200%

Let's look at another example of how buying Call Options can increase your rate of return. It is currently the month of February and through value analysis, you have found that Wal-Mart (WMT) shares are undervalued at $45 and you expect the stock to increase to $55 in 6 months. You can either buy 100 shares of the stock or buy the Call Options. Let's explore both options (no pun intended).

Buying 100 shares of WMT Stock @ $45
Your initial investment = $45 x 100 shares = $4,500
(Scenario: The stock price increases to $55 in 6 months)

You sell the stock at $55, so you receive:
$55 x 100 = $5,500
Your Profit = $5,500 − $4,500 = $1,000

Your rate of return $= \frac{\$1,000}{\$4,500} = 20\%$

If you choose to buy 100 shares of stock, you will have to invest an initial amount of $4,500 for a targeted 20% return on your money. Let's see what happens when you buy the WMT Call Options instead.

Buying the WMT Call Options
You decide to buy one contract of the Sep 45 Call Options @ $2.20 (you find this on the 'Ask' column of the option chain). Note that you have decided to buy 'At the Money' Calls.

Your initial investment = $2.20 x 100 options = $220
(Scenario: The stock price increases to $55 in 6 months)

The intrinsic value of your call is $10 (i.e. $55 – $45). So your call is worth at least $10 now. (note that it should be worth more as you still have time value if you sell it before expiration)

You sell your Call Options at $10, so you receive = $10 x 100 = $1,000

But, you paid $220 to buy the Call Options,
So your NET profit is $1,000 – $220 = $780

Your rate of return $= \frac{\$780}{\$220} =$ **355% return!**

Note: Since we expect the WMT shares to increase in price within 6 months, we buy the Sept Options (which gives us about 7 months to expiration) as we intend to always sell our Calls 30 days before expiration.

As you can see, by using Call Options, we are able to invest much less to control a large quantity of stock. This allows us to generate returns of, way above 100%! So what's the catch? The catch is that if the stock does not move above our breakeven point, we stand to lose 100% of our investment (premium we paid).

Of course in reality, you would not allow this to happen. You would sell your losing options way before expiration to limit your loss to no more than 50% of your initial investment.

To ensure that you really understand the mechanics of Buying Calls, please take the time to do the following exercise below.

Exercise 1: Buying Calls On Immucor Inc (Ticker Symbol: BLUD)

It is currently 1 Nov 2006. You identify that BLUD (currently trading at $25.97) is a momentum stock that could increase to $31.16 in the next 3 months. You decide to purchase one contract of March 25 Calls to take advantage of this.

Table 1: Option Chain for Immucor (BLUD)

Screen capture from Optionsxpress.com

Calls									
Symbol	Last	Chg	Bid	Ask	Vol	OpInt		Strike	Symbo
Mar 07 Calls		(141 days to expiration)						BLUD @ 25.97	
QMQCW	0	0	8.90	9.20	0	0	trade	17.50	QMQOV
QMQCD	6.60	0	6.80	7.10	0	23	trade	20.00	QMQOI
QMQCX	5.30	0	4.90	5.10	0	77	trade	22.50	QMQO)
QMQCE	2.75	0	3.30	3.50	0	83	trade	25.00	QMQOI
QMQCF	1.55	0	1.25	1.40	0	174	trade	30.00	QMQOI

By referring to the Option Chain given above, calculate the following:

1. How much would it cost to buy one contract?

My initial investment is ______________________________

2. What is your breakeven point?
(i.e. Strike Price + Option Premium)

My breakeven point is ______________________________

3. If BLUD goes to $31.16 in 3 months, what is the minimum profit you would make?
(i.e. Stock Price – Strike Price – Option Premium)

4. Draw the Risk-Return Graph

Check Your Answers to Exercise 1

1. How much would it cost to buy one contract?

My initial investment is **$3.50 x 100 options = $350**

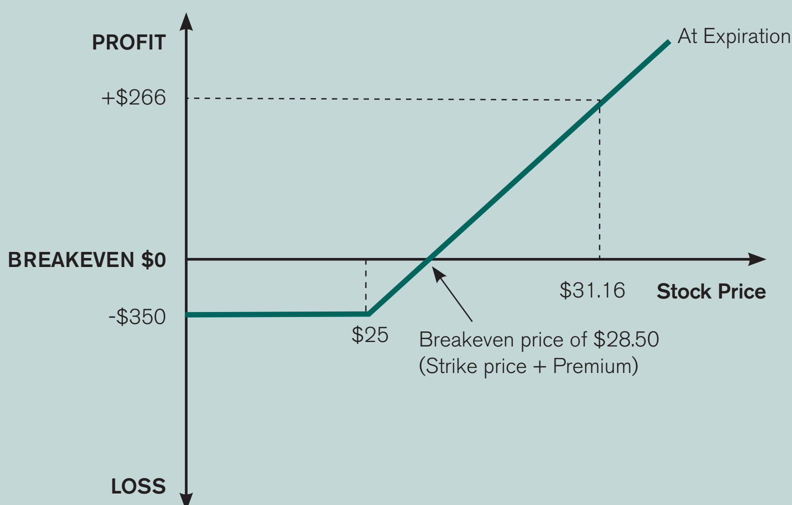
2. What is your breakeven point?
(i.e. Strike Price + Option Premium)

My breakeven point is **$25 + $3.50 = $28.50**

3. If BLUD goes to $31.16 in 3 months, what is the minimum profit you would make?
(i.e. Stock Price – Strike Price – Option Premium)

My minimum profit = **($31.16 – $25 – $3.50) x 100 options = $266**

4. Draw the Risk-Return Graph



Buying Calls: Make The Profits & Exit The Trade

With buying shares of stock, closing your position is pretty straightforward. When the stock price moves up, simply sell your shares and collect your money. If the stock price decreases, then you can choose to sell and cut your losses when any of the criteria for value (9 criteria) or momentum (7 criteria) stocks is violated.

What about Call Options? When and how should you sell them to take your profits or cut your losses? Before you buy any Calls Options on bullish stocks, you need to plan on WHEN and HOW you are going to exit your trade. Here are three common scenarios that could happen:

Scenario 1: Sell The Call Options for a Profit

This is the most common way to exit the trade. When the stock price moves beyond the breakeven point and your Call Options increase in value, you sell them for nice profit 30 days before expiration Friday!

For example, BLUD stock is trading at $25.97 and you expect it to increase to $31.16. You buy one contract of BLUD March 25 Calls at $3.50 and pay $350 ($3.50 x 100 Calls).

From your calculations earlier on, you find that BLUD's stock price must increase beyond $28.50 for you to breakeven.

If BLUD's stock price increases to $31.16, your Call Options will now be worth $8.16 (Intrinsic value of $6.16 + Time value of $2).

So, you will sell your 100 Calls for $8.16 and receive $816.

Since you paid $350 for your Calls, you gain a profit of $466 ($816 – $350) giving you a 133% return on investment!

Scenario 2: Exercise the Calls Before Or On Expiration

In this scenario, you exercise the Call Options at expiration and buy 100 BLUD shares at the lower strike price (i.e. $25) Then, you sell the shares in the market at the higher price of $31.16, gaining you a profit of $616 (($31.16 – $25) x 100).

Since you paid $350 to buy 100 Calls, your net profit is $266 (i.e. $616– $350). This is very RARELY USED by Options traders as it involves having to actually buy the shares and re-selling it.

By waiting till expiration to exercise your Calls, you actually make lesser profits than in the first scenario, since your options have lost all its 'time value'.

Scenario 3: Cutting Losses

There is always a possibility the stock price will not increase within the time frame or worse, it may move against you! Remember that the stock has to increase beyond the breakeven price of $28.50 (Strike Price + Option Premium) for you to make a profit (at expiration).

Instead of waiting until expiration when your time value and the price of your options goes to zero, it is better to cut your losses and sell the Call early to avoid losing your entire investment.

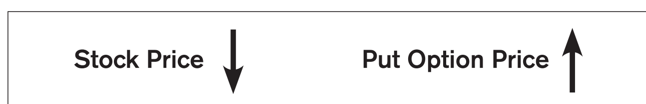
I usually cut my losses and sell my Call Options when:

1. The Call Options premium drops 50% below the price I paid
2. Any of the criteria of Value or Momentum investing are violated. (e.g. the stock reverses into a downtrend)
3. There are 30 days left to expiration.

Understanding 'Delta'

Remember that as an Options Trader, you are interested in having the price of your Call Options increase as the stock price increases. This way, you can sell your calls for a profit.

Similarly, if you bought a Put Option, you would want the price of your Puts to increase as the stock price falls.



So, for every dollar the stock price increases, how much does your Call Option premium increase? This is measured by a Greek symbol called 'Delta'.

'Delta' is the change in the option price relative to the change in the underlying stock price. So if Delta is 0.80, it means that for every $1 increase in the stock's price, the Call Option's premium will increase by $0.80.

For Put Options, the Delta is always negative. This is because as the stock price decreases, the Put Option premium increases. This inverse relation causes the Delta to be negative. For example, if the Delta is -0.80, it means that for every $1 decrease in the stock price, the Put Option price will increase by $0.80. Similarly, if the stock price increases by $1, the Put price will decrease by $0.80.

The Delta of an Option depends on whether it is 'In the Money', 'At The Money' or 'Out of The Money'. When a Call or Put is very deep 'In The Money', the Delta is '+1' (for Calls) & '–1' (or Puts). This means that for every $1 the stock price increases, each Call Option increases by $1 & each Put option decreases by $1 respectively.

When the Option is very much 'Out of the Money', then the Delta is anywhere from '0 to 0.50' (for Calls) and '0 to –0.50' (for Puts). For example, if the delta is 0.30, it means that for every $1 the stock price increases, the Call will only increase in value by $0.30.

'At The Money' Calls are ALWAYS '0.50' and 'At the Money' Puts are ALWAYS '–0.50'. As the Option moves from 'Out of the Money' to 'In The Money', the Delta will increase until it reaches '1' (for Calls) or '–1' (for Puts).

Delta for Calls is 0 to +1	Delta for Puts is 0 to -1
ITM Call is 0.50 to 1 Deltas	ITM Put is –0.50 to –1 Deltas
ATM Call is 0.50 Deltas	ATM Put is –0.50 Deltas
OTM Call < 0.50 Delta	OTM Put > -0.50 Deltas

Delta can also be thought of as the probability that the Option will end up 'In the Money' at expiration. This is why ATM Options are 0.50 (or –0.50). This is because there is a 50% chance the ATM calls will move ITM or OTM.

Although buying Calls and Puts which are deep 'into the money' are much more expensive, the deltas are higher so your option price will increases faster as the stock price increases.

In Table 2 below are the BLUD Jan Call Options. BLUD is currently trading at $26.77 which is why strike prices $25 and below are ‘in the money’ (in yellow). As you can see in the Option Chain below, Options that are deeper ‘in the money’ have much larger deltas.

Table 2: Option Chain for Immucor (BLUD)

Screen capture from www.optionsxpress.com

Strike	Symbol	Last	Bid	Ask	Theo Value	Open Interest	Delta	Gamma	Rho	Theta	Vega
January 2007											(66 days to e
17.50	QMQAW	6.80	9.30	9.60	9.437	44	0.999	0.001	0.031	-0.003	0.001
20.00	QMQAD	7.30	7.00	7.20	6.993	52	0.98	0.012	0.035	-0.004	0.006
22.50	QMQAX	5.10	4.80	5.00	4.714	146	0.894	0.044	0.035	-0.009	0.021
25.00	QMQAE	2.95	2.95	3.10	2.786	334	0.72	0.083	0.03	-0.013	0.038
30.00	QMQAF	0.80	0.70	0.85	0.674	608	0.277	0.081	0.012	-0.012	0.038

‘In the Money’ Calls

‘Out of the Money’ Call

Delta increases as options are more ‘in the money’

Summary: Sequence for Buying Calls

Let’s now put everything you have learnt together and look at the step-by-step sequence for using Call Options to make money on stocks that you are bullish on.

Step #1: Find a Bullish Stock

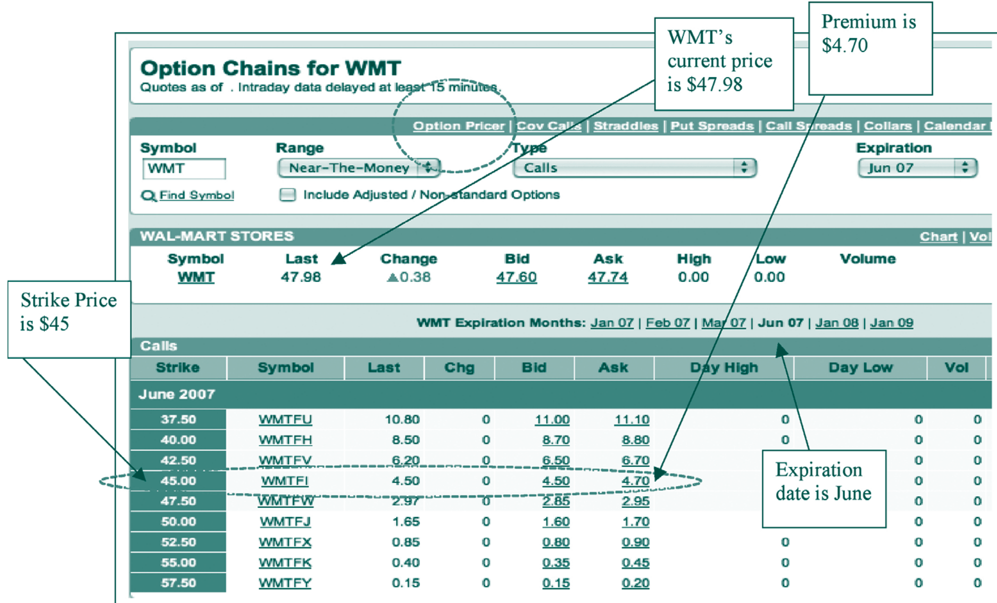
Using the 9 Step Value Investing Criteria or 7 screens for Momentum Investing, identify a stock which you are confident will increase in value over a particular period of time. (Also check if it is optionable).

For example, you may identify that Wal-Mart is a value stock that will increase in value over the next four months.

Step #2: Check the Option Chain

Go to an online broker like www.optionsxpress.com and key in the stock symbol and click on ‘CHAINS’. You will then be presented with all the Options Chains. From here, you will see an Option Chain like in Table 3.

Table 3: Screen capture for www.optionsxpress.com



Option Chains for WMT
Quotes as of . Intraday data delayed at least 15 minutes.

Option Pricer | Cov Calls | Straddles | Put Spreads | Call Spreads | Collars | Calendar

Symbol: WMT — Range: Near-The-Money — Type: Calls — Expiration: Jun 07

Find Symbol — Include Adjusted / Non-standard Options

WAL-MART STORES — Chart | Vol

Symbol	Last	Change	Bid	Ask	High	Low	Volume
WMT	47.98	▲0.38	47.60	47.74	0.00	0.00	

WMT Expiration Months: Jan 07 | Feb 07 | Mar 07 | Jun 07 | Jan 08 | Jan 09

Calls

Strike	Symbol	Last	Chg	Bid	Ask	Day High	Day Low	Vol
June 2007								
37.50	WMTFU	10.80	0	11.00	11.10	0	0	0
40.00	WMTFH	8.50	0	8.70	8.80	0	0	0
42.50	WMTFV	6.20	0	6.50	6.70		0	0
45.00	WMTFI	4.50	0	4.50	4.70		0	0
47.50	WMTFW	2.97	0	2.85	2.95		0	0
50.00	WMTFJ	1.65	0	1.60	1.70		0	0
52.50	WMTFX	0.85	0	0.80	0.90	0	0	0
55.00	WMTFK	0.40	0	0.35	0.45	0	0	0
57.50	WMTFY	0.15	0	0.15	0.20	0	0	0

a. Choose an Expiration Month

For momentum stocks, I usually buy Calls that have expiration dates that are more than 90 days to 120 days. As for value stocks, I may buy Calls that have expiration dates that are over 6 months. If we expect WMT to increase in price within 4 months, then we should buy options that are 5 months to expiration (since we always sell 30 days before expiration date). So, I would choose the WMT June Calls in this case.

b. Choose a Strike Price (OTM, ATM or ITM)

You can buy Calls that are 'In the Money', 'At the Money' or 'Out of the Money'. Note that the more 'In the Money' your Calls are, the higher the Delta and the higher the probability that your Calls will be 'In the Money' at expiration. Remember that the higher the price of the Options and the lower your rate of return will be.

In this case, we decide to buy WMT Calls with a strike price of $45. Since WMT shares are currently priced at $47.98, we are buying calls that are 'In the Money'.

c. Check the Call Option Price (see the 'Ask' column)

Check how much it costs to buy one contract of Options by taking the option price and multiply by 100. In this case, one contract of WMT June 45 Calls can be bought at $4.70. So our investment is $470 per contract.

d. Check the Option Delta & Volatility

Next click on 'Option Pricer' to check the Delta of the Call Option. Recall that the Delta tells us how much the Calls value will increase for every $1 increase in the stock price. From Table 4, the Delta for WMT June 45 Calls is 0.797. This means for every $1 increase in WMT stock price, your Calls will increase in value by $0.797.

Table 4: Finding The Delta For WMT calls

Screen capture from www.optionsxpress.com

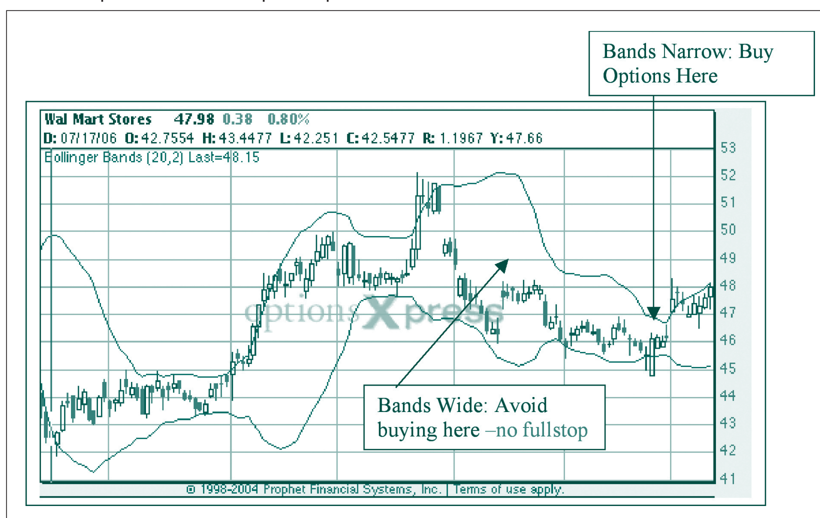
calls puts

Strike	Symbol	Last	Bid	Ask	Theo Value	Open Interest	Delta	Gamma
June 2007								
37.50	WMTFU	10.80	11.00	11.10	11.305	347	0.995	0.003
40.00	WMTFH	8.50	8.70	8.80	8.91	625	0.972	0.012
42.50	WMTFV	6.20	6.50	6.70	6.633	5489	0.912	0.031
45.00	WMTFI	4.50	4.50	4.70	4.593	442[illegible]	0.797	0.055

You will recall that the volatility of the stock affects the price of the options. You should only buy options when the stock's current volatility is low (so options are cheaper). When the stock becomes more volatile, your options will then increase in value. The way to check this out is to look at the stock's price chart and apply 'Bollinger Band Studies'. These bands tell you when the stock has low volatility (bands are narrow) and when it has high volatility (bands are wide). Again, you should only buy options when the bands are narrow.

Chart 4: Bollinger Bands For WMT

Screen capture from www.optionsxpress.com



Step # 3: Draw the Risk Graph & Determine Breakeven Point

Always draw the Risk-Return graph to know where your breakeven point is. You should know exactly how to do this by now… right?

Step #4: Place a Buy Order with Your Broker

Once you are satisfied that your Calls meet up to the criteria and there is a good chance of making a good profit, place a buy order with your broker. In this case, you would buy one contract of WMT June 45 Calls at $4.70.

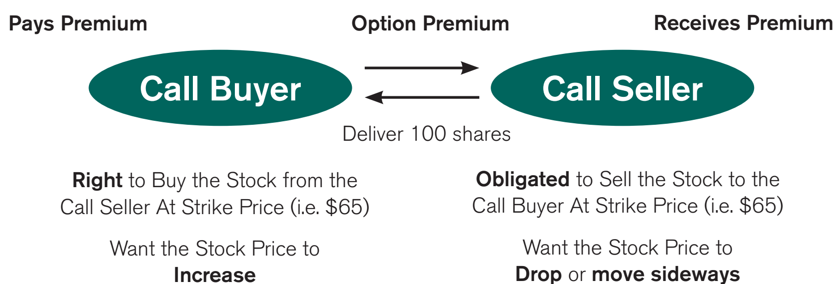
Step #5: Have an Exit Strategy

As mentioned earlier, always have an exit strategy to TAKE PROFITS when the stock price increases in your favour or to CUT LOSSES when the stock price drops. You can do this manually or place automated sell orders with your broker.

Strategy 2: Selling Covered Calls

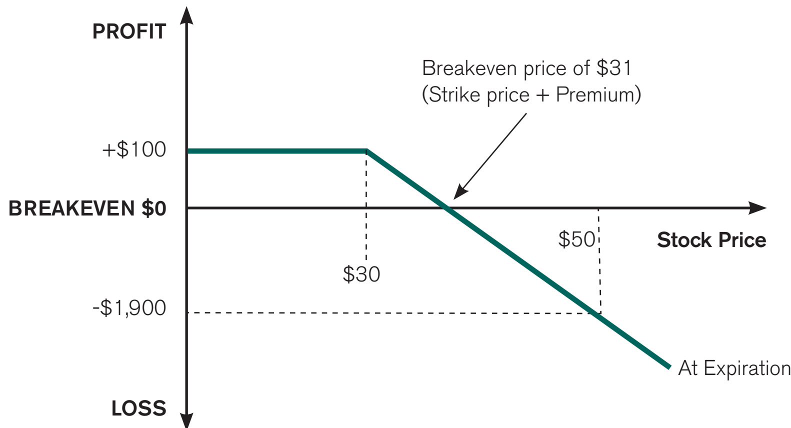
Now that you have learnt how to make money by BUYING Calls, let's see how you can reduce your risks and boost your returns by SELLING Calls. Usually selling Call Options without actually owning the shares; (known as selling Calls naked) leads to unlimited risk. However, if you actually own the shares of a company, selling calls written on these shares are actually a great way to increase your income and to reduce your risks.

First, let's do a quick review of what it is like to sell Call Options. Remember than when you SELL a Call Option, you receive the option premium that is paid to you by the option buyer. However, as the SELLER you have the OBLIGATION to deliver 100 shares at the strike price once it is exercised by the Call buyer. Look at the transaction diagram again.



Let's take a look at the Risk-Return graph of a Naked Call Seller. If you sold one contract of JNJ Jan 30 Call at the premium of $1 (1 contract = 100 options). This is what the graph will look like:

Chart 5: Risk-Return Graph of A Naked Call Seller at Expiration i.e. Sell One Contract of Johnson & Johnson (JNJ) Call Options



Selling Calls Naked

As the Call Seller, you immediately receive the Option Premium of $1 x 100 options = $100.

If the stock price remains at $30 or below, the Call Buyer will not exercise his Call and let it expire worthless. You will get to keep the $100 for free. So, the most you can earn as a SELLER is the premium received. As indicated on the graph above, your profit is LIMITED to $100.

What if the stock price increases beyond $30? Say to $50? The Jan 30 Call you sold becomes 'In The Money' and the Call Buyer will exercise his option.

As the SELLER, you are obligated to sell 100 shares at $30. If you don't own any shares, the broker will lend you the shares to sell. So, you receive $30 x 100 = $3,000. You then have to buy 100 shares from the market at $50 to return to the broker. So you pay $50 x 100 = $5,000

You make a loss of + $3,000 – $5,000 = –$2,000. Offset this by the $100 you received and you still make a net loss of –$1,900. As indicated on Chart 5, when the stock price hits $50, you lose $1,900. What if the Stock increases to $100? You will lose –$6,900! As a result, your risk is UNLIMITED.

Selling Calls without actually owning the stock is known as SELLING CALLS NAKED. It is something you should NEVER DO as it exposes you to limited returns but unlimited risks.

Selling Covered Calls: A Strategy To Reduce Risk And Boost Returns

Selling covered calls is when you sell calls on stock which YOU ALREADY OWN. This strategy gives a NO RISK, LIMITED RETURN strategy to a stock-owner. Let's see how you can employ this in your stock portfolio.

Example: After doing a thorough value analysis, you find that Tyco International (Ticker Symbol: TYC) shares are undervalued and you buy 100 shares at $23.

Step 1: In January, You Buy 100 shares of TYC@ $23

Your initial investment = $23 x 100 shares = $2,300
(Scenario: The stock price increases to $26)

Your TYC stock is now worth = $26 x 100 shares = $2,600

This gives you a $300 profit and a 13% return

Step 2: You Decide to Sell TYC Feb 30 Calls at $0.40
(Calls are 30 days to expiration)
(By selling the Calls, you now have the obligation to sell 100 shares of TYC at the strike price of $30 should the Call buyer exercise his right.)

You receive the premium of $0.40 x 100 = $40 (instant cash)

This gives you an additional 1.7% return per month! ($40 ÷ $2,300)

If you keep doing this every month, you will get $480 a year
($40 x 12 months)

This is an EXTRA 20.87% return a year! ($480 ÷ $2,300)

So, what are the likely scenarios that could happen after this? Let's explore the three possibilities.

Scenario 1: TYC Stock Price Increases Above Strike Price (i.e. $30)
"What would happen if the stock price increased above $30, to say $35?"

The Call you sold will be 'In the Money' & the Call buyer would exercise the option.

You will be obligated to sell your 100 TYC shares at $30.

You will receive $30 x 100 shares = $3,000

Since you first bought the shares at $23, you make a nice $700 profit (30.4% return)

So, what's the catch? The catch is that you miss out on the chance to sell your stock at the market price of $35!

Scenario 2: Stock Price Remains Below the Strike Price (i.e. $30)
In this case, the Call Options you sold expires worthless

You get to keep the $40 premium for FREE

Again, keep repeating this process every month and get an extra annual return of 20.9% (i.e. ($40 x 12) ÷ $2,300)

* *It may be worth noting that over 80% of Options expire worthless.*

As you can see, in selling covered calls, you make a profit no matter what happens. Of course, the only downside is that you miss out on the chance of selling your shares for a higher market price should the stock price suddenly jump.

If the stock happens to fall BELOW your initial purchase price, selling Calls actually reduces your potential loss! Let's see how…

Scenario 3: TYC shares drop to $22
(You first bought TYC at $23)
Since the stock price is below the Strike Price (i.e. $30), the Options expire worthless and you get to keep the premium of $40.

Your paper loss from the stock is ($22 − $23) x 100 shares = −$100

But, you received an extra $40 in premium

So, your paper loss is reduced to −$60 (−$100 + $40)

If you do decide to sell your 100 TYC shares at $22, your loss will be reduced to $60 as a result of your selling of Calls. However, if TYC is still worth keeping and it eventually bounces back, you would get that extra premium of $40 as free cash!

Strategies for Selling Covered Calls

Before you get really excited and start selling Calls on all the stock positions you own, there are a few important points that you have to bear in mind.

1. Only Sell Calls When You Already Own An Existing Stock that is Worth Holding

Some 'Option Experts' teach their students to go out and buy 100 shares of stock for the sole purpose of writing calls on them. This is an extremely risky move as most of these option traders who have poor fundamental knowledge on stocks go and buy overvalued stocks (or stocks that fail the 9 criteria). As a result, the stocks decrease drastically in price, causing them to lose lots of money.

Instead, you should only sell covered calls on stocks that YOU HAVE ALREADY BOUGHT based on the 9 criteria for value stocks. I highly suggest you do not write calls on momentum stocks. The stocks must still be good companies, which you believe will appreciate in value, though they are currently in a consolidation pattern.

2. Sell Calls With The Shortest Expiry Period. (i.e. 30 days)

In Selling Calls, you would want to choose options with the SHORTEST expiry (30 days) so the option can expire worthless soon and you are freed from your obligation and can pocket your premium.

3. Sell Calls 1-2 Strikes Out Of The Money

If the stock price is currently at $20, you would obviously want to sell Calls with strike price of $25 or $30 (1–2 strikes out of the money). Selling Calls 'In The Money' is too risky as there is a higher chance it will be exercised.

4. Do Not Sell Calls if You Think the Stock will Jump Above the Strike Price Within 30 Days

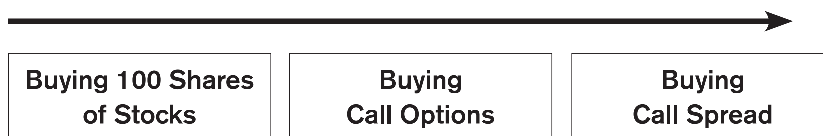
If you think that your stock will jump in the next 30 days above the strike price, then avoid selling calls. If so, you will lose the additional profit potential. Of course they is no way to be 100% sure of this but I would recommend not selling calls when the stock is on a strong uptrend!

Strategy 3: The Bull Call Spread

In the earlier part of this chapter, you have seen how buying Call Options allow you to use a small amount of capital to control a large quantity of stock. You also learnt how Call Options provide you with limited risk and the prospect of unlimited returns.

Is there a way of reducing your investment and risk even further? You may not believe it but the answer is a resounding 'YES!' by utilizing a strategy called the 'Spread'.

In this case, since it involves using Call Options on bullish stocks, it is called a 'BULL CALL SPREAD'.



So what is this strategy and how could it reduce your investment and risk even further?

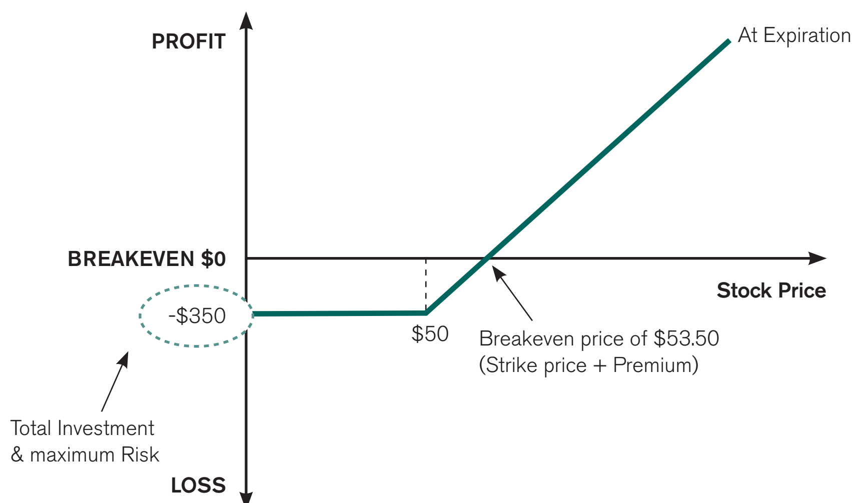
A Bull Call Spread is a strategy where you BUY a Call Option on a stock which you believe will increase in price. However, you also simultaneously SELL a Call Option on the same stock at a HIGHER strike price. The Calls that you buy and & sell together must have the same expiration date.

Bull Call Spread:
Buying a Call with a Lower Strike Price and simultaneously…
Selling a Call with a Higher Strike Price…
With the Same Expiration Date

When you buy a Call Option, you have to pay the option premium. This premium is your investment and it is the total amount you could risk to lose if your options expire worthless.

For example, WMT's stock price is undervalued at $51 and you expect it to increase to $55. If you want to buy a straight Call Option, you could buy one contract of WMT Sep 50 Calls. Since the strike price of $50 is below the current price of $51, you have bought an 'In the Money' Call. The Risk-Return graph will be as follows:

Chart 6: Risk-Return Graph for Buying One Contract WMT Sep 50 Call at $3.50



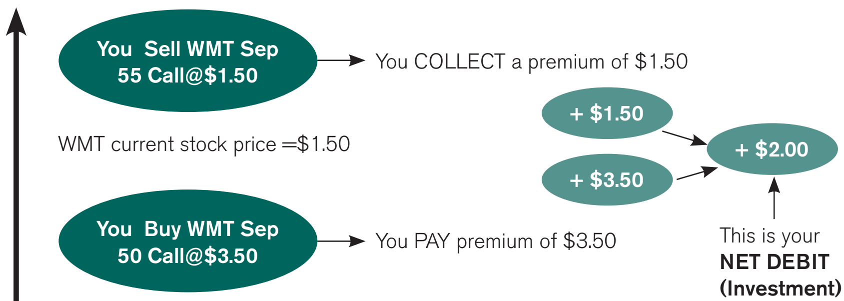
In the case of buying a straight Call, your total investment is the Call premium paid = $350 ($3.50 x 100 options) and it is your maximum risk.

Create a Spread by Selling a Call at a Higher Strike Price

Since your target for WMT share price is $55, you could SELL a Call Option with a Strike Price of $55 and collect the premium money! If WMT Sep 55 Call is $1.50, then you collect the $1.50!

The premium money you collect by selling this Call (Higher Strike price of $55) can offset the cost of buying your first Call (Lower Strike Price of $50)! As a result, your initial investment is reduced! You now only have to fork out $200 ($2 x 100 options) as compared to $350 ($3.50 x 100) when you only bought a straight Call.

This $200 is known as the NET DEBIT of the Bull Call Spread. It is the maximum risk you take on this trade.



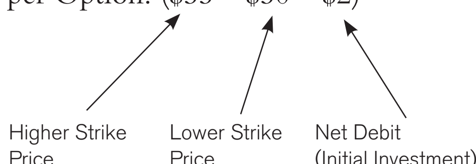
* *Note that the Call with the higher strike price has a lower premium. This is always the case since a more 'Out of the money' Call will be less valuable.*

'Bull Call Spreads' Not Only Limit Your Risk, They Also Limit Your Potential Returns

By buying the WMT Sep 50 Call, you have the RIGHT to BUY 100 shares of WMT at $50.

However, by selling the WMT Sep 55 Call, you are OBLIGATED to SELL 100 shares of WMT at $55.

So, by having the RIGHT to BUY at $50 and SELLING at $55, your Maximum Profit will be $3 per Option! ($55 – $50 – $2)



As a result, 'Bull Call Spreads' give you a LIMITED RETURN, however at a LOWER LIMITED RISK!

Your Return to Risk Ratio

So, is a 'Bull Call Spread' a worthwhile investment? Well, let's examine the example given on Wal-Mart (WMT)…

Your Maximum Risk = Net Debit = -$3.50 + $1.50 = -$2

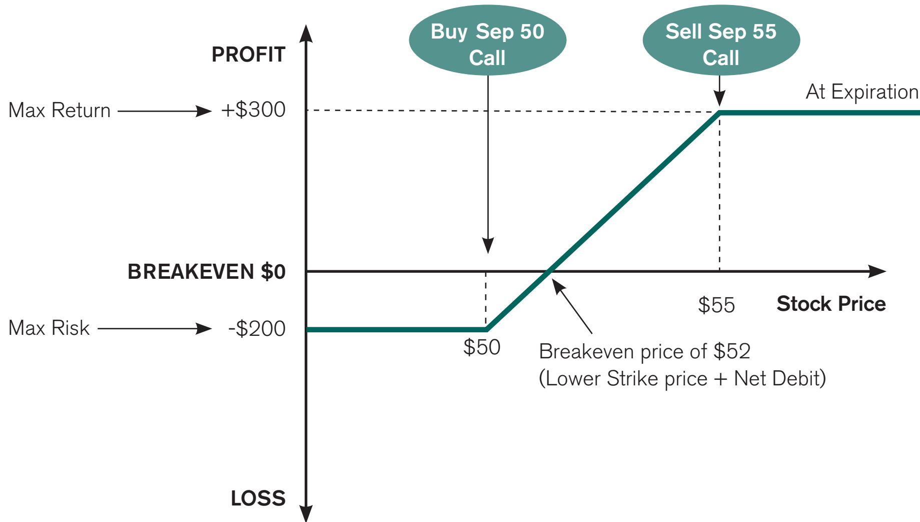
Your Maximum Return = Higher Strike price – Lower Strike Price – Net Debit = $55- $50 - $2 = $3

So your Return-Risk Ratio is $3 ÷ $2 = 1.5

This means that for every $1 you invest, you can potentially earn $1.5. That's a 150% return on investment! Sounds like a good deal to me.

Before executing a 'Bull Call Spread', always calculate your Return-Risk Ratio. If it is more than '1', then it is considered a good deal. Now, let's see what the Risk-Return graph looks like using this strategy.

Chart 7: Bull Call Spread:
Buy One Contract WMT Sep 50 Call at $3.50
Sell One Contract WMT Sep 55 Call at $1.50



As you can see from the graph above, if WMT's stock price falls below $50, your maximum risk is limited to $200. This is the net debit of the trade. You can also see that WMT's stock price must rise above the breakeven price of $52, for your trade to be profitable. The breakeven price = Lower Strike Price + Net Debit.

However, no matter how much the stock price rises, your maximum return is limited to $300 ($3 x 100 options). This is because by selling a Call Option with a strike price of $55, you will be obligated to sell 100 shares of stock at $55, once the stock price rises above this value.

To Summarize, for a Bull Call Spread…

Your Maximum Risk (Investment)
= Premium of Sold Call – Premium of Bought Call
= Net Debit
i.e. (+$1.50 – $3.50) x 100 shares = –$200

Your Maximum Return
= Higher Strike Price – Lower Strike Price – Net Debit
i.e. ($55 - $50 – $2) x 100 = $300

Breakeven Point = Lower Strike Price + Net Debit
i.e. $50 + $2 = $52

Key Strategies in Profitable 'Bull Call Spread Trades'

Before using this powerful options strategy, there are a few important key points that I want to bring to your attention. These few tips can make the difference between a losing trade and a highly profitable one.

1. Return- Risk Ratio Above '1'

Before entering a trade, always calculate your maximum risk and your maximum return for your 'Bull Call Spread'. This is shown in the summary table above.

A trade is only worthwhile if your Maximum return/Maximum Risk is above '1'. This means that for every $1 of risk you take, you can make a potential of $1 or more in return. In other words, your potential rate of return should be greater than 100%!

In fact, this is the minimum you should demand. Most of the spread trades that I go into have a Return-Risk ratio of '2'. Meaning, I get a 200% return on my money!

2. Strike Prices Must Be At Least $5 Apart

The next important key point is that the Strike Price of your sold Call & the Strike price of your Bought Call should be at least $5 apart!

For instance, in the previous example, you bought the WMT Sep 50 Call and sold the WMT Sep 55 Call. Here, the strike prices ($50 & $55) are exactly $5 apart! Anything smaller than $5 will not make your spread very profitable at all!

In fact, in most of my spreads, I usually buy and sell Calls that have strike prices $10 apart! This gives me lots more potential profit. It also means that the premium I get from my sold Call is lower (since it is much further 'out of the money').

When you use strike prices more than $5 apart, you would want to Buy & Sell Calls that have a longer time to expiration. Yes, they may be more expensive but you are giving the stock a lot more time to reach its targeted price.

3. The More 'In the Money' Your Calls Are, the Lower the Risk

The most common question that people ask me is whether the bought Call should be 'In the Money' and the sold Call 'out of the money'. Or should both Calls be 'Out of the Money'?

For example, if WMT is currently trading at $51, should I buy the Sep 50 Call & sell the Sep 55 Call like in the left table? Or should I buy the Sep 55 Call & Sell the Sep 60 Call in the right table?

Buying One Call 'In the Money' & selling One Call 'Out of the Money'		Buying One Call 'Out of the Money' & selling One Call 'Out of the Money'	
WMT Sep Calls		**WMT Sep Calls**	
WMT Sep 60 Calls	**Out of the Money**	(WMT Sep 60 Calls)	← **Sell**
(WMT Sep 55 Calls)		(WMT Sep 55 Calls)	← **Buy**
	WMT@$51		WMT@$51
(WMT Sep 50 Calls)		WMT Sep 50 Calls	
WMT Sep 45 Calls	**In the Money**	WMT Sep 45 Calls	
WMT Sep 40 Calls		WMT Sep 40 Calls	

Well, there is no one correct answer to this. It all depends on how much risk you are willing to take and how much potential return you want to reap. By buying both Calls 'Out of the Money'; your investment will be much less, giving you a higher potential profit.

However, there is higher risk as the stock price must increase much more for your Calls to be 'In the Money'. By buying one call 'in the money' and selling one call 'Out of the money', you will have a slightly lower return but it will be much less risky.

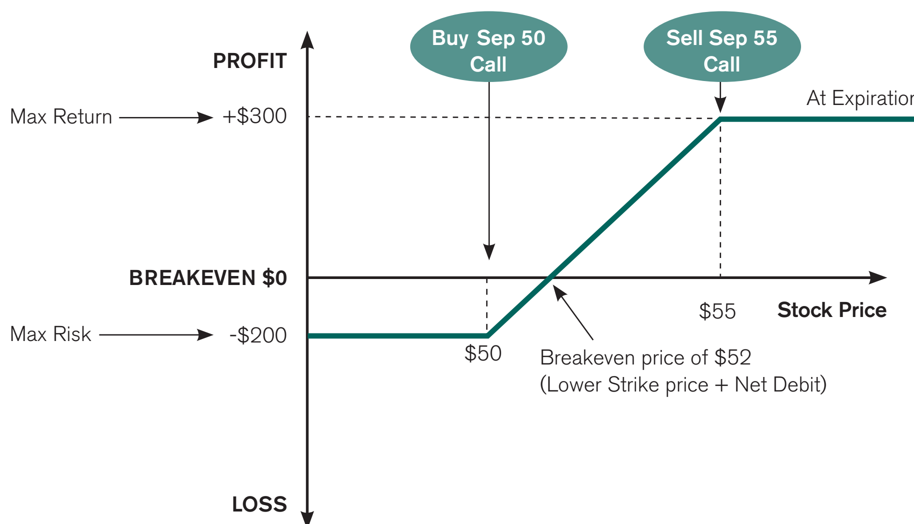
Bull Call Spreads: Make the Profits & Exit the Trade

Now that you know exactly how to calculate and enter a spread trade, you have to know how to exit your trade. With buying straight Calls, closing your position is pretty straightforward. When the stock price moves up, simply sell your Calls and collect your money.

In the case of a 'Bull Call Spread', you have opened the trade by Buying a Call and Selling a Call. So, your strategy for exiting your trade becomes a little bit more complicated.

Let's refer to the earlier chart on WMT. I have duplicated the graph here so that you would not have to refer to the earlier pages.

Chart 8: Bull Call Spread:
Buy One Contract WMT Sep 50 Call at $3.50
Sell One Contract WMT Sep 55 Call at $1.50



Here are four common scenarios that could occur:

Scenario 1: WMT Stock Price Increases Above $55
If WMT's stock price goes above $55, the Sep 55 Call you sold becomes 'In the Money'. The Buyer of the Call will exercise his right to buy 100 shares from you at $55. As the Call seller, you are OBLIGATE to sell the shares.

You sell 100 shares of WMT stock at $55 and will therefore receive $5,500.

So how will you get these 100 shares? Well, you will exercise your Sep 50 Call and buy 100 shares at $50. Your cost will be $5,000 ($50 x 100).

Remember that you spent a net debit of $200 on your 'Bull Call Spread'

So, your Net Profit = $5,500 – $5,000 – $200 = $300!

Since your initial investment was $200, your rate of return would be 150%!

Scenario 2: WMT Stock Price is Between $52 and $55
In this instance, WMT's stock price is above your breakeven price of $52 and below your maximum profit target price of $55. So how do you close your trade?

Step 1: Buy back the Sep 55 Call which you sold earlier (for a small loss)
Step 2: Sell the Sep 50 Call which You Bought earlier for a nice profit

The result of the two above transactions will be a net profit on your trade. In reality, the two transactions can be done simultaneously as one transaction. Most online brokers allow you to close your 'Bull Call Spread' as a single order.

Scenario 3: WMT Stock Price is Between $50 and $52
If WMT's stock price does not increase beyond your breakeven point of $52, you will make a slight loss. In this case, you can do the following:

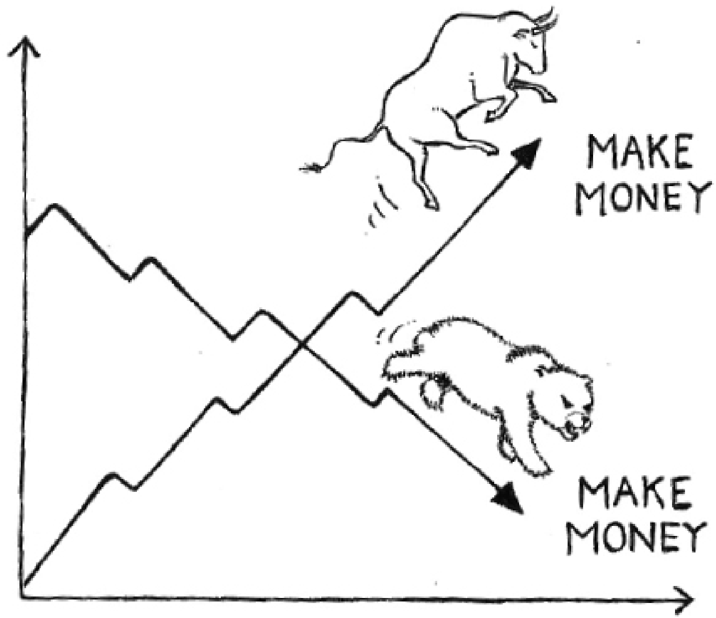
Step 1: Sell your Sep 50 Call for a slight loss
Step 2: Let the Sep 55 Call you sold expire worthless so you can keep the premium you received to mitigate your loss.

Scenario 4: WMT Stock Price Drops Below $50
If WMT's stock price reverses into a downtrend and drops below $50, then it would be a good idea to cut your losses. Remember to always cut your losses, and allow more than 30 days before the expiration date so that you don't lose all the time value in your options. In this case, do the following:

Step 1: Sell your Sep 50 Call at a loss
Step 2: Let the Sep 55 Call you sold expire worthless

So, there you have it! You have learnt three powerful Call Option strategies (i.e. buying straight Calls, selling covered Calls and using Bull Call Spreads) that you can combine with the value and momentum investing strategies that you have learnt earlier on this book. In the next chapter, we are going to explore how we can make money when the market moves downwards.

8 How to Make Money in Any Direction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8

How to Make Money in Any Direction

Talk to most people and the majority of them would only understand the concept of making money only when stock prices rise in value. In fact, many people only understand the concept of buying something at a low price and selling it at a high price. As a result, the masses tend to panic and fear recessions, downturns and bear markets as it could wipe out their hard earned savings. They tend to sit on the sidelines until the time comes when the economy and market sentiment improves and prices start rising again.

However, the best investors in the world can make huge profits no matter which direction stock prices take! When Enron Corporation's stock price plunged from US$90 to US$0.30 in 2001, after it was found to have hidden billions of dollars in losses through accounting fraud, and people had their entire life savings wiped put, there were also many smart investors who made millions in the process! When the Dot Com bubble burst in 2001 and stock markets plunged by over 50%, smart investors made huge fortunes at the same time!

Wouldn't you like to learn how to do this? Wouldn't you like to make huge profits no matter what the market does? While most people have to wait for a bull run in the stock markets to make money, you will be able to make money in a bear market and even in a prolonged period of consolidation (i.e. stock prices move sideways).

Introduction to Short Selling

So far, you have learnt how to make money when a stock appreciates in value. Basically, it is to buy when stocks/calls are at a low price and sell when stocks/calls move to a high price.

What many people do not know is how they can make money when they expect a stock's price to FALL. Traditionally, when stock traders expect a stock to fall from its current price of say, $50 to $35, they would SHORT SELL the stock. What this means is that they will SELL the stock NOW at $50 (without owning the stock) and they will then BUY it back later at the lower price of $35. So, by selling HIGH ($50) and buying LOW ($35), they make a profit of $15 per share.

One question that confuses most beginners is 'how do you sell stock you do not own?' Well, your broker will LEND YOU the shares to sell at the high price. You must then go and buy the shares at the lower market price (within a certain period of time) and return it to the broker. This entire transaction is done automatically when you short sell stock (also known as 'sell to open' and 'buy to close').

Short Selling Leads To Unlimited Risk of Loss

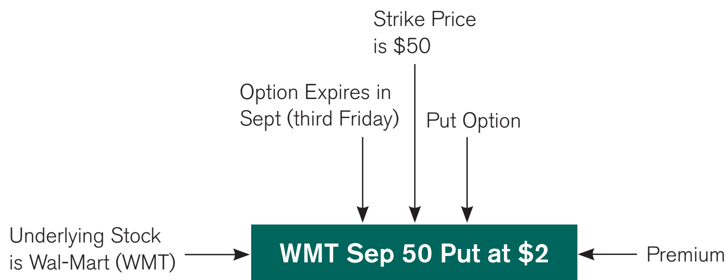
However, I do not encourage you to engage in short-selling of stocks unless you are extremely experienced. This is because if the stock does not fall as expected, you can suffer unlimited loss. For example, let's say Osim's stock price is $1.60 and after posting disappointing financial results, you expect the stock to fall to $1.40. You short sell 10,000 shares at $1.60 and collect $16,000. However, you must buy back the shares within two days to return it to your broker. What if Osim's share price suddenly surges to $2? Then you will have to buy 10,000 shares at $2 and fork out $20,000. You suffer a loss of $4,000!

Now that I have burst your bubble, let me share with you a way of profiting from falling stocks in a much safer way. A way that allows you to have very limited loss but extremely high returns!

The answer is in purchasing Put Options. The added advantage is that you can purchase Put Options with much long expiration dates of months or years. Even if the stock does not fall in price immediately, you can happily wait until the price falls and pocket your profits.

Buying Puts to Profit from Stock Falls

First, let's refresh your memory on what Put Options are. A Put Option is a contract that gives you the RIGHT to SELL 100 shares of stock at a predetermined price (i.e. STRIKE PRICE) on/before the EXPIRY DATE. A Put Option is typically stated this way…



For example, if you buy a 'WMT Sept 50 Put' contract at $2, it means that you have the RIGHT to SELL 100 shares of WMT Shares at $50 on or before the third Friday of September.

You would do this because you are BEARISH and expect WMT's stock price to fall BELOW $50!

For example, if the stock drops to $35, then you could then exercise your option and sell 100 shares of stock to the Put Seller at $50. You can then go into the market and buy 100 shares at $35.

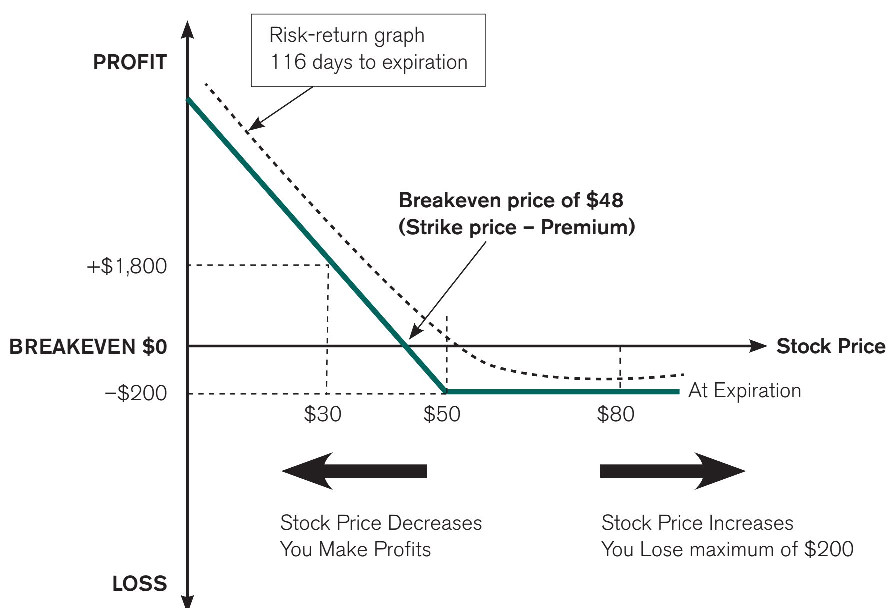
By selling at $50 and buying back at $35 (Sell High, Buy Low), you make a profit of $15 on each share. Since one option contract is always 100 shares, your profit will be $15 x 100 = $1,500! Since you had to pay $200 ($2 premium x 100 options) to buy the Put Options, your net profit will be $1,500 – $200 = $1,300.

In fact, it has been said that the 9/11 terrorist attack on the US World Trade Center was not just an act of terrorism. It was also financially motivated. It was also a strategy for the terrorists to profit handsomely from the panic selling that they knew will happen in the stock markets.

Terrorists were found to have bought millions of dollars of Put Contracts of the US stock market indexes. When the planes hit, the Dow Jones stock market index fell 684 points, or 7.1%, its biggest-ever one-day point decline. By the end of the week, the Dow had fallen 1369.7 points (14.3%), its largest one-week point drop in history. Those who bought Put Contracts made hundreds of millions of dollars within a week.

So what would the Risk-Return graph look like? Assume that WMT is currently trading at $50 and you expect the price to fall. You buy one contract of WMT Sep 50 Puts at a premium of $2 (Option is 'At The Money'). You now have the right to sell 100 shares of WMT at the strike price of $50.

Chart 1: Risk-Return Graph of a Put Option Buyer (At Expiration)
Buy One Contract of WMT Sep 50 Puts At $2



From Chart 1 you can see that your risk is only limited to the premium you paid for the Put Option contract (i.e. $200). So, even if you are wrong and the stock increases above $50, your maximum loss is always $200. As shown in the graph, when the stock price is $80, your maximum loss is only $200.

Even if the stock price does not move, you also stand to lose your $200. In fact, WMT's stock price must fall below the breakeven price of $48 for you to start making money. The breakeven price is calculated by taking Strike Price – Premium = $50 – $2 = $48. Since you have paid the premium of $2 per option, the stock MUST move $2 BELOW the strike price of $50 BEFORE you can make a profit!

Although your loss is limited, you enjoy high upside potential! If the stock price decreases to $30, you get a profit of $1,800! The lower the stock goes, the more you earn.

How do you get $1,800? Well, remember that you own the right to SELL the stock at $50. So if the stock goes to $30, you can SELL the shares at $50 and buy it back for $30, giving you a $20 profit per share (+$50 –$30). Since you control 100 shares, your profit is $20 x 100 = $2,000.

But remember that you paid $200 to buy the Options contract. So your actual NET profit is $2000 – $200 = $1,800.

In reality, Option traders rarely exercise their Put Options and actually sell the shares at a high price and buy them back at a low price. As the stock price plunges, the INTRINSIC VALUE of the Puts will increase (recall Intrinsic value of Put = Strike Price – Stock Price). The Options trader will sell his Puts at a higher price (premium) for a profit!

The dotted line on Chart 1 shows the Risk-to-Return graph with 116 days left to expiration. In reality, we will usually sell our Puts way before the expiration date so we can actually earn higher profits with the time value remaining. So, by buying Puts with long expiration dates and selling them early, you can make profits even if the stock price does not decrease below the breakeven price.

To summarize,
Your Maximum risk (loss) = Option Premium paid
(i.e. $2 x 100 shares = $200)

Your Profit = Strike Price – Stock Price – Option Premium
(i.e. $50 – $30 – $2) x 100 = $1,800

Breakeven Point = Strike Price – Option Premium
(i.e. $50 – $2 = $48)

Case Study: S&P 500 Index ($SPX)

On 12 Jan 2007, The S&P 500 Index is at a 6-year high of 1,423.82 points. By observing the 4-year trend line, you notice that it is at the very top of the resistance line, so you expect a downward correction to the support line (i.e. 1,350 points) within four months.

Chart 2: 4-Year Stock Chart for S&P 500 Index ($SPX)

Screen capture from www.optionsxpress.com

Hence, you decide to buy Puts on the S&P 500 Index (symbol SPX). You can buy Puts of stock indexes as well as individual stocks.

You decide to buy one contract of SPX June 1425 June Puts at $38.10 which is 'In the Money'. This contract gives you the right to sell 100 shares of SPX at $1,425 before/on the third Friday of June 2007.

Table 1: Option Chain for SPX June Puts

Screen capture from www.optionsxpress.com

Expiration Month

S&P 500 INDEX — Chart | Volatility View | News | Xspreads

Symbol	Last	Change	Bid	Ask	High	Low	Volume
SPX	1423.82	0.00	1423.31	1424.27	0.00	0.00	

SPX Expiration Months: Weekly | Jan 07 | Feb 07 | Mar 07 | Jun 07 | Sep 07 | Dec 07 | Jun 08 | Dec 08 | Dec 09 | LSX Options

Puts

Strike	Symbol	Last	Chg	Bid	Ask	Day High	Day Low	Vol	Open Int	Return Static	Return Unassigned	
June 2007											(153 days to expiration)	
1,365.00	SXYRM	27.80	0	20.40	22.40	0	0	0	387	1.52%	1.52%	Trade
1,375.00	SXYRO	23.20	0	22.50	24.50	0	0	0	35,962	1.66%	1.66%	Trade
1,400.00	SXZRT	29.00	0	28.70	30.00	0	0	0	57,503	2.09%	2.09%	Trade
1,425.00	SXZRE	42.50	0	36.10	38.10	0	0	0	17,011	2.51%	2.60%	Trade
1,450.00	SXZRJ	[illegible]	0	45.70	47.70	0	0	0	9,072	1.39%	3.25%	Trade
1,475.00	SXZRO	63.00	0	57.70	59.70	0	0	0	222	0.46%	4.07%	Trade

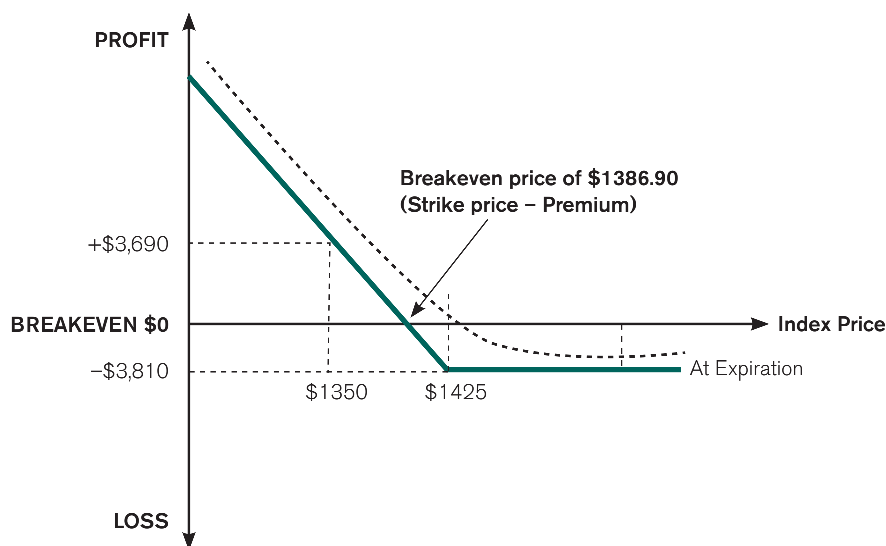
Strike Prices

You can buy SPX June 1,425 Puts at $38.10

Let's look at the details of this transaction.

Your initial investment = Total Premiums = $38.10 x 100 options = $3,810. This $3,810 is the maximum you can lose if you let the options expire worthless. Your Breakeven Price = Strike Price – Premium = $1425 – $38.10 = $1,386.90. At expiration, the S&P 500 must fall below 1386.90 for you to start making profits. This is what the Risk-Return graph of this transaction will look like at expiration.

Chart 3: Buy One Contract of SPX June 1425 Puts at $38.10



So, how much do you stand to profit if the S&P 500 corrects down to 1350 within the next 4 months (your options expire in June 2007)? When SPX is 1350, your Puts would have an intrinsic value of Strike Price – Stock Price = 1425 – 1350 = $75. Since one contract is 100 options, you can sell your Puts for at least $7,500. However, you spent $3,810 to buy your 100 Put Options. Your net profit will therefore be $7,500 – $3,810 = $3,690 (this is 96.85% return in less than 4 months)

Exercise 2: Buying Puts on Falling Stocks

Now, it's your turn to do the next exercise. On 03 March 2006, Comverse Technology (symbol: CMVT), currently trading at $25.30, has been hit by an options accounting scandal. The stock has begun to reverse into a downtrend.

You believe that the stock could drop by 20% to $21 in the next 3 months. You decide to purchase one contract of CMVT July 25 Puts (slightly 'out of the money'). From the Option Chain on your online broker's site, you find that the July 25 Puts are trading at $0.90. From this information, calculate the following:

1. How much would it cost to buy one contract?

My initial investment is ________________________

2. What is your breakeven point?
(i.e. Strike Price – Option Premium)

My breakeven point is ________________________

3. If CMVT drops to $23 in 3 months, what is the minimum profit you will make? (i.e. Strike Price – Stock Price – Option Premium)

4. Draw the Risk-Return Graph

Check Your Answers for Exercise 2

1. How much would it cost to buy one contract?

My initial investment is $0.90 x 100 options = $90 per contract

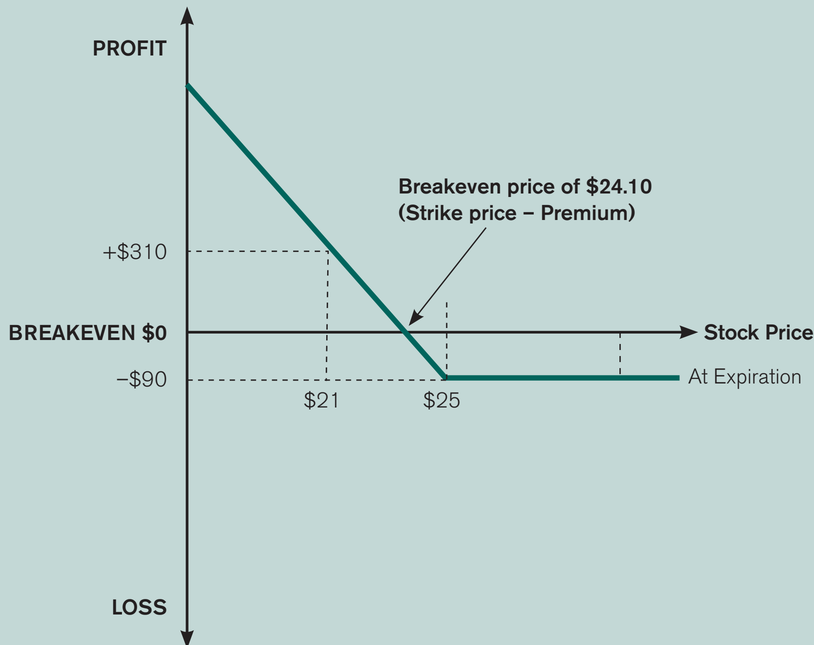
2. What is your breakeven point?
(i.e. Strike Price – Option Premium)

My breakeven point is $25 – $0.90 = $24.10

3. If CMVT drops to $21 in 3 months, what is the minimum profit you will make? (i.e. Strike Price – Stock Price – Option Premium)

Minimum Profit = ($25 – $21 – $0.90) x 100 options = $310
This represents a 244% return on investment

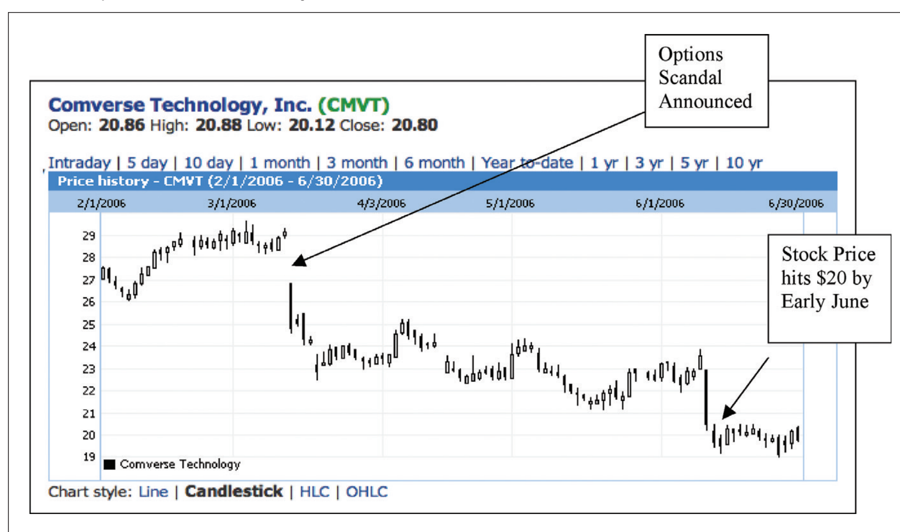
4. Draw the Risk-Return Graph



In actual fact, CMVT continued its downward trend as ongoing investigations for the options accounting scandal revealed more problems for the troubled company (See chart 4). By early June, the stock hit a low of $20. At this price, your Put Options contract would have been worth $410, giving you a 355% return on investment.

Chart 4: Stock Chart for Comverse Technology (CMVT)

Screen capture from www.moneycentral.com



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Buying Puts: Make The Profits & Exit The Trade

As with the case with buying Calls, you need to have a plan of WHEN and HOW you are going to exit your trade before you buy Puts on a stock. Here are three common scenarios that could happen:

Scenario 1: Sell The Put Options For A Profit

This is the most common way to exit the trade. When the stock price moves down below the breakeven point and your Put Options increase in value, you sell them for nice profit 30 days before the expiration date!

For example, CMVT stock is trading at $25.30 and you expect it to fall to $21. You buy one contract of CMVT July 25 Puts at $0.90 and pay $90 ($0.90 x 100 Puts).

From your calculation earlier on, you find that CMVT's stock price must fall below $24.10 for you to breakeven.

If CMVT's stock price drops to $21 before 30 days the expiration, your Put Options will now be worth $4.30 (Intrinsic value of $4 + Time value of $0.30).

So, you will sell your 100 Puts for $4.30 and receive $430.

Since you paid $90 for your Calls, you achieve a profit of $340.

Scenario 2: Exercise The Puts Before Or On Expiration

In this scenario, you exercise the Put Options and sell 100 shares of CMVT stock at the higher strike price (i.e. $25). Then, you buy the stocks back at the lower market price of $21. This gives you a profit of $400 ($4 x 100 shares).

Since you paid $90 for the 100 Put Options, Your net profit is $310 ($400 – $90). This is very RARELY USED by Options traders as it involves you short selling the shares and buying it back.

Scenario 3: Cutting Losses

There is always a possibility the stock price will not fall enough within the expected time frame or worse, it may move against you! Remember that the stock has to DECREASE beyond the breakeven price (Strike Price – Option Premium) for you to make a profit (at expiration).

Instead of waiting until expiration when your time value and the price of your options goes to zero, it is better to cut your losses and sell the Put early to avoid losing your entire investment.

I usually cut my losses and Sell my Put Options when:
1. The price of the Put Options drop 50% below the price I paid
2. The stock starts to reverse into an uptrend
3. There are 30 days left to expiration

Identifying Bearish Stocks

The big question I am often asked is, 'how do I find stocks that will keep falling in value?'. Well, it is actually much more difficult to identify stocks that will continue to fall in price as compared to finding stocks that will appreciate in value. This is why I recommend bearish plays only to more experienced investors who have mastered the art of buying bullish stocks first.

The most common reason for a stock to decline is because of bad news that causes investors to lose faith in the company's ability to continue increasing earnings at the projected rate.

The most common reasons that cause a stock to fall are:

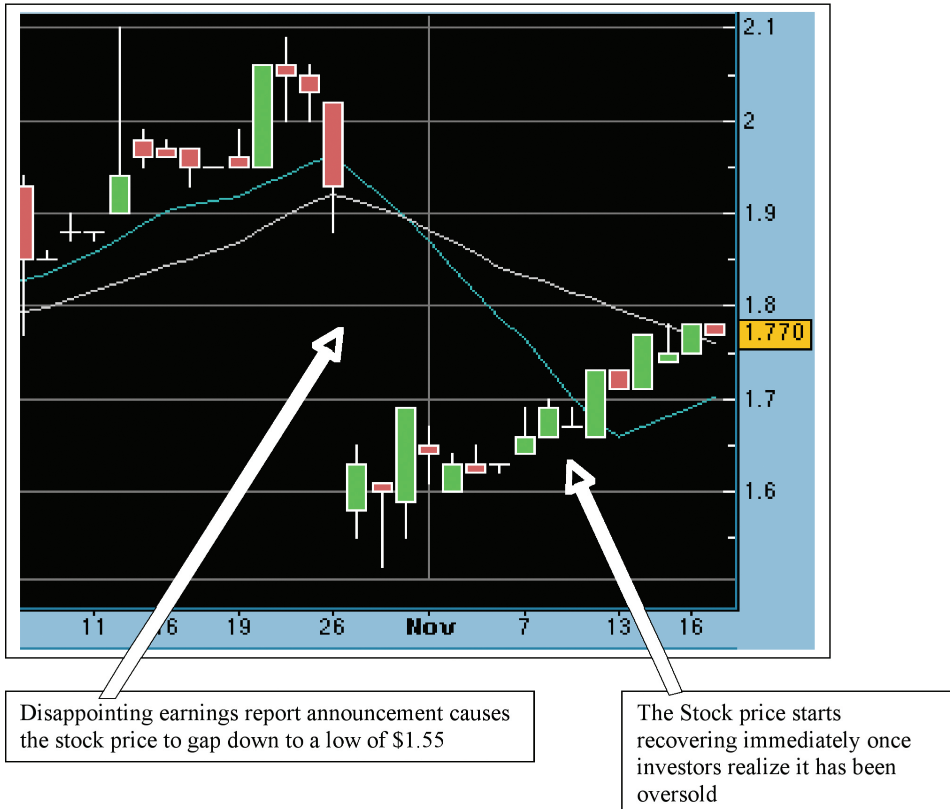
1. The company reports earnings (on a quarterly basis) that are below analysts' forecast
2. The company loses its competitive advantage (e.g. A drug company loses its patent on a best selling drug)
3. The company is being investigated for accounting irregularities
4. Analysts downgrade the stock as a result of any of the above reasons
5. The economy is in a recession and the whole stock market is in a downtrend, pulling every stock down with it

Remember that in the chapter of Value Investing, we said that the market tends to over-react to bad news and send the stock crashing down way below its intrinsic value? After the initial sell-off, what usually happens is that the market will come to its senses and soon realize that the stock has been oversold and is way undervalued. Buyers will then return and the stock price will rise again. Sometimes, this could happen very quickly and the stock will jump back up within a day! This is where inexperienced short sellers (or Put buyers) get caught and find that the stock they expect to fall is now rising instead!

When Osim International (Listed on SGX) announced its first ever quarterly loss, its stock price gapped down from $1.93 to $1.55 the moment trading started. However, it started rising just as fast and was up to $1.77 within 19 days. Short sellers who expected the stock to continue dropping would have been sorely disappointed and a lot poorer!

Chart 5: Stock Chart for Osim International

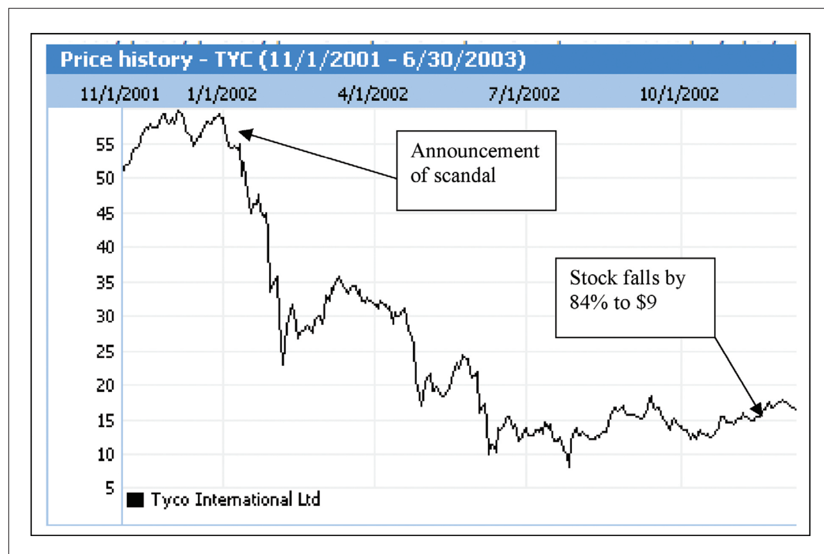
Screen capture from www.shareinvestor.com



The skill is to find companies where their stock price will continue to fall lower and lower and take a long time to recover. A good example would be Tyco International (TYC) where the stock fell continuously for seven months from $57 (Jan 2002) to a low of $9 (Aug 2002) as a result of a huge scandal involving the CEO & CFO stealing $600 million from the company and committing securities fraud. It then took the stock over 12 months to start climbing up slowly.

Chart 6: Stock Chart for Tyco International (TYCO)

Screen capture from www.moneycentral.com



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The Put buyers' dream would be to find a stock that keeps falling until it reaches zero (the company goes bust). The most famous examples would be energy giant Enron Corp and telecommunications giant WorldCom Inc. When it was discovered that Enron hid billions of dollars worth of losses through accounting manipulation, its stock price fell from $90 to $0.30 and then to $0 once it collapsed into bankruptcy. Soon after, another accounting scandal caused WorldCom's shares to free-fall from $64.50 to $0.20 and then to nothing.

So how do you tell the difference between a company whose stock price will likely recovery quickly from bad news and one whose stock price will continue falling over a period of time?

Avoid Shorting Stocks When the Bad News Seems Temporary

Usually, when the bad news hits a company's short-term profitability but DOES NOT affect its competitive advantage to grow earnings in the future, its stock price will usually turn around after the initial decline.

Most companies who report lower than expected quarterly earnings usually fall into this category. There are many factors that could cause a company's profits to drop temporarily. They are rising material cost, failed products, poor acquisitions and a temporary drop in demand. These are stocks that you would NOT want to buy Put Options on.

When the Bad News is Permanent, Go for the Kill!

I usually buy Puts on stocks which I am very confident will continue to decline for a couple of weeks or even months! These are stocks hit by bad news that causes long-term or permanent damage to its profitability of financial stability.

The best bets are when a company is being investigated for accounting fraud. This process usually drags on for months or even years and the fear & uncertainty about the extent of the damage keeps buyers away and allows sellers to push the stock even further down.

In such scandals, there is also a big possibility that even more bad news will be uncovered. As more dirt is dug up, it will usually send the stock price spiraling downwards.

For example, when AIG was first investigated for accounting irregularities, it was believed that it inflated its earnings artificially by about $1 billion. As investigations went on, the figure got larger and larger. These sequence of events caused AIG stock to continue its decline from $78 to $51.

What makes the stock decline even stronger is when a company is being pounced on and regularly attacked by the media. For example, when Tyco's CEO was first being investigated for stealing millions of dollars, the media kept playing up the bad news almost every hour on CNN and CNBC. This bad publicity caused even more panic and sent the stock to spiral down even faster!

One reason why I love betting on such falling stocks is because stock prices tend to fall a lot faster (from bad news) than they rise (from good news). As a result, you earn your profits much faster!

The Four Indications that a Stock Will Dive

It is not everyday that you can find a company that is hit with such bad news that its stock price crumbles apart. You have to be patient and strike only at the right opportunity.

By regularly reading business news on CNN.com, Briefing.com and watching CNBC, you will be alerted to these investment opportunities as they happen. While there is no sure way to guarantee that a stock will fall below our breakeven point, there are five key criteria that I use to increase my chances…

1. Screen for Stocks that Decline Significantly on High Volume

I screen for stocks that suffer a significant one-day (intra-day) decline on high volume. Usually, stocks that suffer such a drastic fall in one day experience some kind of significant negative news.

I also look for stocks that decline by more than 20%-30% with volume exceeding at least 300,000 shares. The easiest way to screen such stocks is to go to www.moneycentral.com.

Use their 'Power Search' tool to screen for 'Intraday High Volume Losers' or 'Gapping Down Today'. If you can not find any on that particular day, select 'Weekly High Volume Losers' or 'One Month Volume Losers' to see if any stocks fit the bill over the last week. A sample screen shot (Table 2) is shown below. On this particular day, there are stocks that have declined more than 20% on high volume. For example, on a particular day Digital River (DRIV) was found to have declined by 3.86% to $51.87.

Table 2: Power Search Tool for Intraday High Volume Losers

Screen capture from www.moneycentral.com

Power Searches

More Stock Searches

View: Intraday High-Volume Losers Go

Stocks that have lost 3% or more in today's trading on at least double the average trading volume of the past quarter.

Intraday High-Volume Losers

Symbol	Company Name	Last Volume	Avg. Daily Vol. Last Qtr.	Prev Day's Mkt Capitalization	% Price Change Today	Last Price
AMD	Advanced Micro Devices, Inc.	123.3 Mil	22.89 Mil	11.07 Bil	-9.51	18.26
SYMC	Symantec Corporation	36.67 Mil	13.9 Mil	20.01 Bil	-3.98	20.48
CVC	Cablevision Systems Corporation	20.80 Mil	1.436 Mil	8.647 Bil	-4.09	28.39
NWACQ	Northwest Airlines Corporation	19.27 Mil	5.069 Mil	483.6 Mil	-12.82	4.83
POOL	Pool Corporation	6.271 Mil	430,331	2.058 Bil	-10.42	36.35
STEM	StemCells, Inc.	5.868 Mil	2.647 Mil	260.7 Mil	-9.25	3.04
EPL	Energy Partners, Ltd.	3.188 Mil	618,554	874.1 Mil	-3.34	21.69
NFLX	Netflix, Inc.	3.168 Mil	1.345 Mil	1.659 Bil	-6.31	22.71
ONSM	Onstream Media Corp	2.961 Mil	1.213 Mil	50.85 Mil	-4.94	3.27
DRIV	Digital River, Inc.	2.683 Mil	1.056 Mil	2.168 Bil	-3.86	51.87
VOL	Volt Information Sciences, Inc.	2.650 Mil	252,232	987.8 Mil	-16.11	53.00

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2. Ensure Bad News with Sustainable Effects

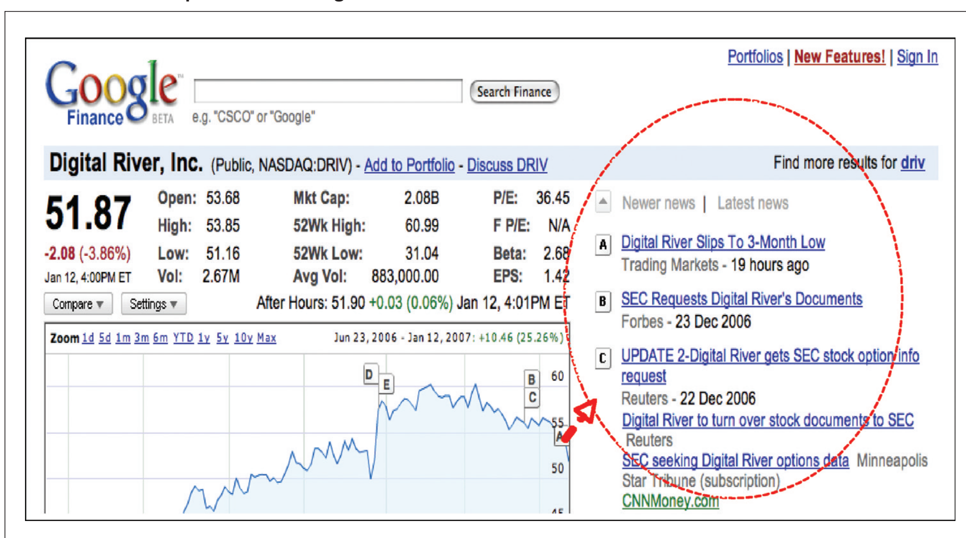
Remember that we are only interested in news that has the potential to create long-term or permanent damage to the company's financial stability or profitability. Again, the ideal bearish play would be an 'accounting scandal' that could drag on for months and result in a long lasting sell-off in the stock.

Sometimes, a major strategic miscalculation could lead to a company losing its competitive advantage and cause long-term effects on its profitability. A good example is when Ford Motor Company made a strategic mistake (failing to focus on smaller, fuel efficient cars) that caused its market share to decline consecutively over 10 years, sending its stock price down from $16 in 2004 to as low as $6 in 2006.

By going to http://finance.google.com or any other business news site, you can read about the news that has triggered the price fall. Bear in mind that it is not every day or every month that you can find a stock that fits this criterion. If you key in 'Digital River' or DRIV into

Google's finance site, you can see that DRIV's recent stock decline was triggered by an investigation from the SEC (Securities Exchange Commission) on the company's stock option practices. Hmmm… could this be another scandal in the making? It is really too early to tell at this stage but you can definitely put DRIV on your watch list as a potential stock that could decline further.

Table 3: Screen Capture from Google Finance



Google Finance images (c) Google Inc. Used with permission.

3. Fundamental Criteria

You would also want to ensure that the stock that you are betting on is highly overvalued, giving a good reason for the market to correct the stock downwards.

Applying what you have learnt in the chapter on value investing, use the 'Intrinsic Value Calculator' (found on www.thewaytomakemoney.com) and calculate the intrinsic value of the stock. You will want to make sure that the current share price is higher than the intrinsic value. It is also important that the current share price is above $8.

4. Technical Criteria

In the last chapter, we learnt that in screening for potential momentum stocks that would move up in price, we need to ensure that 'Technical Indicators' were strong and indicating a 'buy signal'. In the case of buying Puts on falling stocks, we are looking at the opposite. We are looking for weak indicators that signal a 'sell signal'.

Here are a few factors that I look at;

a. Stock is in a Strong Downtrend at High Volume

The stock price should already be moving in a downtrend with increasing volume. Remember that when a stock is in a strong trend, it is more likely to stay on that course until a reversal happens.

b. The Stock Price Crosses Below the 20-Day or 50-day Moving average

When a stock's price moves down and crosses below its 50-day moving average, it is a strong indicator that the stock will continue its decline. If the 20-day moving average crosses below the 50-day moving average, it will indicate even stronger downward momentum.

c. Institutional Selling

Remember that financial institutions and funds make up more than 70% of a stock's traded volume. So if institutions are heavily selling the stock, then it is a clear sign that the stock price will decline further. Again, you can go to www.moneycentral.com and look under 'Ownership' to check the number of institutions selling the stock as compared to buying it.

d. Analyst Downgrade

Just like for momentum investing, you would want to check on how stock analysts grade the stock. If analysts give the stock a grade of 'Sell' or 'Strong Sell', it again gives us the confidence of the stock's continued decline. Again, go to moneycentral.com and look under 'Analyst Ratings'.

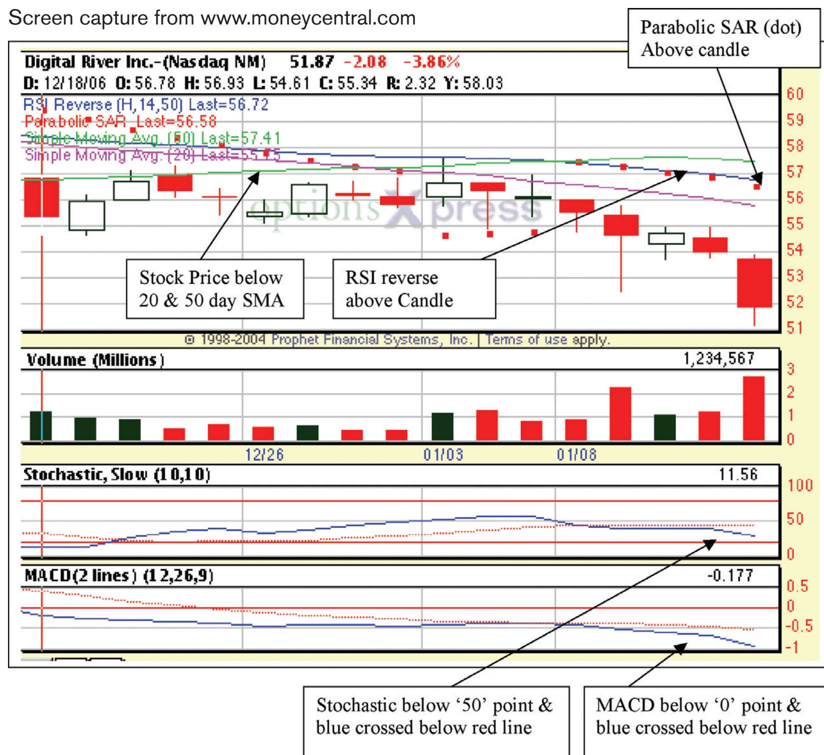
e. Technical Indicators Signal a Strong 'sell signal'

Finally, before you decide to buy a Put Option, check that all the four technical indicators (you learnt in 'Momentum investing') point to a strong sell signal. As a person who wants the stock to fall in price, look for:

- The MACD in the bearish region (below '0' mark) with the blue line crossing below the red line
- The Slow Stochastic in the bearish region (below '50' mark), with the blue line crossing below the red line
- The Parabolic SAR dot should be above the candlestick (i.e. price)
- The RSI Reverse line should be above the stock price candlesticks

Chart 7 shows a declining stock (i.e. DRIV) that has all the technical indicators giving a 'sell signal'.

Chart 7: Stock Chart for Digital River (DRIV)



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Summary: Sequence for Buying Puts

So, let's put together everything and summarize it into a five-step process to identify and profit from falling stocks.

Step #1: Find A Bearish Stock

Use the 'Four Indications that a Stock Will Dive' to identify the stock that you believe will decline over a particular period of time.

For example, you may identify that Digital River (DRIV) is a stock that will continue to decrease within the next few days.

Step #2: Check the Option Chain

Go to an online broker like www.optionsxpress.com and key in the stock symbol and click on 'CHAINS'. You will then be presented with all the Options Chains as shown on Table 4.

Table 4: Digital River (DRIV) Put Option Chain

Screen capture from www.moneycentral.com

Option Chains for DRIV
Quotes as of .

DRIV's current price is $51.87

Premium is $5.20

Option Pricer | Cov Calls | Straddles | Put Spreads | Call Spreads | Collars | Calendar P

Symbol: DRIV | Range: Near-The-Money | Type: Puts | Expiration: Mar 07

Find Symbol | Include Adjusted / Non-standard Options

DIGITAL RIVER — Time & Sales | Chart | Vola

Symbol	Last	Change	Bid	Ask	High	Low	Volume
DRIV	51.87	▼-2.08	51.87	52.09	0.00	0.00	

Strike Price is $55

DRIV Expiration Months: Jan 07 | Feb 07 | Mar 07 | Jun 07 | Jan 08 | Jan 09

Expiration date is March

Puts

Strike	Symbol	Last	Chg	Bid	Ask	Day High	Day Low	Vol	Open Int	Return Static
March 2007										
45.00	DQIOI	1.30	0	1.15	1.25	0	0	0	[illegible]	2.62%
50.00	DQIOJ	2.55	0	2.55	2.70	0	0	0	[illegible]	5.37%
55.00	DQIOK	5.00	0	5.00	5.20	0	0	0	[illegible]	3.74%
60.00	DQIOL	8.72	0	8.60	8.80	0	0	0	1,986	0.91%

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a. Choose an Expiration Month

I usually buy Puts that have more than 60 days to expiration. So in this example, I would choose the DRIV March Puts. This gives me just over 60 days to expiration (given it is currently January).

b. Choose a Strike Price (OTM, ATM or ITM)

You can buy Puts that are 'In the Money', 'At the Money' or 'Out of the Money'. Again, the more 'In the Money' your Put Options are, the higher the Delta and the higher the probability that your Puts will be 'In the Money' at expiration. However, the higher the price of the Options the lower your rate of return will be.

In this instance, we decide to buy DRIV Puts with a strike price of $55. Since DRIV shares are currently priced at $51.87, we are buying Puts that are 'In the Money'.

c. Check the Put Option Price (see the 'Ask' column)

Check how much it costs to buy one contract of Options by taking the option price and multiply by 100. In this case, one contract of DRIV March 55 Puts can be bought at $5.20. So our investment is $520 per contract.

d. Check the Option Delta & Volatility

Next click on 'Option Pricer' to check the Delta of the Put Option. The Delta tells us how much the Puts value will increase for every $1 decrease in the stock price. From Table 5, the Delta for DRIV March 55 Puts is –0.57. This means for every $1 drop in DRIV's stock price, your Puts will increase in value by $0.57.

Table 5: Finding the Delta for DRIV Puts

Screen capture from www.moneycentral.com

calls ⦿ puts

Strike	Symbol	Last	Bid	Ask	Theo Value	Open Interest	Delta
March 2007							
45.00	DQIOI	1.300	1.150	1.250	1.24	616	-0.196
50.00	DQIOJ	2.550	2.550	2.700	2.996	647	-0.375
55.00	DQIOK	5.000	5.000	5.200	5.721	1248	-0.57
60.00	DQIOL	8.720	8.600	8.800	9.317	1986	-0.74

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Just as in the case of Call Options, ensure that the stock has currently low volatility before buying the Put options. This way, the options will be relatively cheap to buy. Again, look at the stock's price chart and apply 'Bollinger Band Studies'. These bands tell you when the stock has low volatility (bands are narrow) and when it has high volatility (bands are wide).

Chart 8: Bollinger Bands for DRIV

Screen capture from www.moneycentral.com

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Step # 3: Draw the Risk Graph & Determine Breakeven Point

Always draw the Risk-Return graph to know where your breakeven point is.

Step #4: Place a Buy Order with Your Broker

Once you are satisfied that your Puts meet the criteria and there is a good chance of making a good profit, place a buy order with your broker. In this case, your order would be to buy 1 contract of DRIV March 55 Puts at $5.20.

Step #5: Have an Exit Strategy

As mentioned earlier, always have an exit strategy to TAKE PROFITS when the stock price decreases in your favour or CUT LOSSES when the stock price starts consolidating (move sideways) or reverses into an uptrend. You can do this manually or place automated sell orders with your broker.

Straddles: Making Money Up Or Down

So far, you have learnt how to make money when you believe a stock's price is going up (buy Calls) and when a stock's price is going down (buy Puts).

But, what if you have no idea which way the stock's price is headed? For example, a company you have identified will be announcing its quarterly financial results soon. Historically, the stock's price will jump if the actual earnings beat analyst forecast. However, if the actual results are disappointing, the stock's price will take a dive.

Can you make money no matter which way the stock price goes? Absolutely! The strategy is to buy a call and to buy a put at the same strike price and at the same expiration date! This strategy is called a Straddle and it allows you to make money no matter which direction the stock price heads. Let's see how it works.

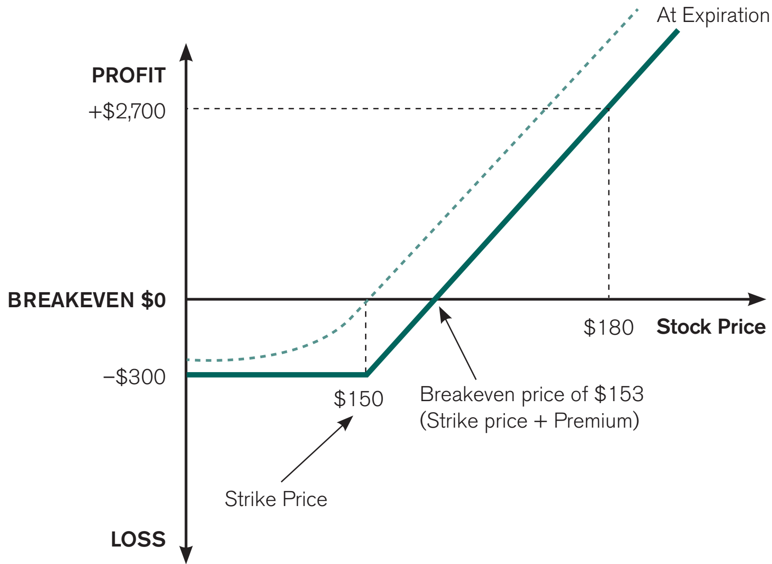
A Straddle is a Strategy Where You Buy One 'At-the Money Call' & One 'At-the Money Put' with the Same Strike Price & the Same Expiration Date

Let's take an example of Goldman Sachs (Symbol: GS) currently trading at $150 per share. It is August 2006 and they will soon be releasing their third quarter financial report. You know historically that the share price will either rise or fall in the week leading up to the earnings release, depending on whether analysts expect the stock to beat its forecast earnings.

You decide to create a Straddle. So you buy a 'GS Dec 150 Call' at $3 and a 'GS Dec 150 Put' at $3. Notice that since the stock price is currently at $150, you are buying 'At the Money' Options. What will your Risk-Return Graph looks like? You will recall that when you buy a Call, the Risk-return graph will looks like this…

When you put the two graphs together (buy a Call & a Put), you will get this Risk-Return Graph…

Chart 9: Buy One Contract of GS Dec 150 Call at $3



Also recall that when you buy a Put, the Risk-return graph will looks like this…

Chart 10: Buy One Contract of GS Dec 150 Put at $3

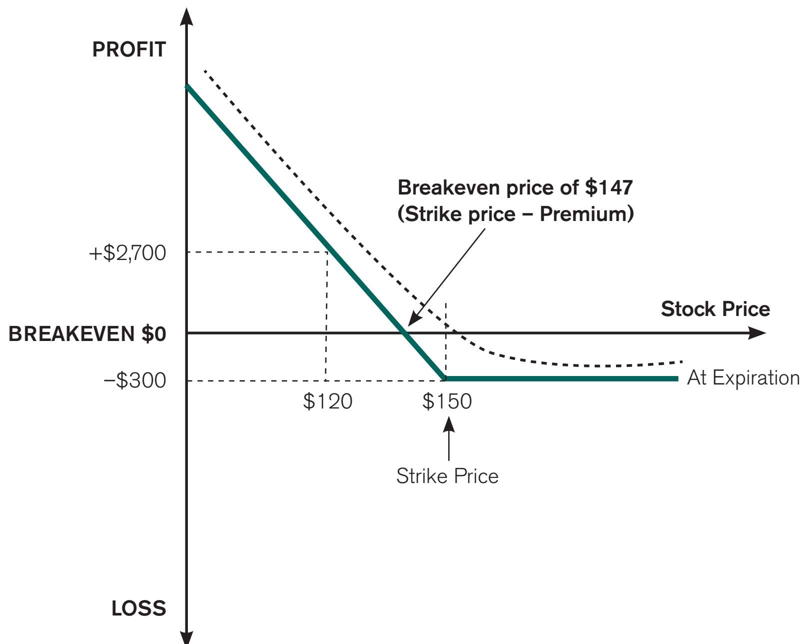
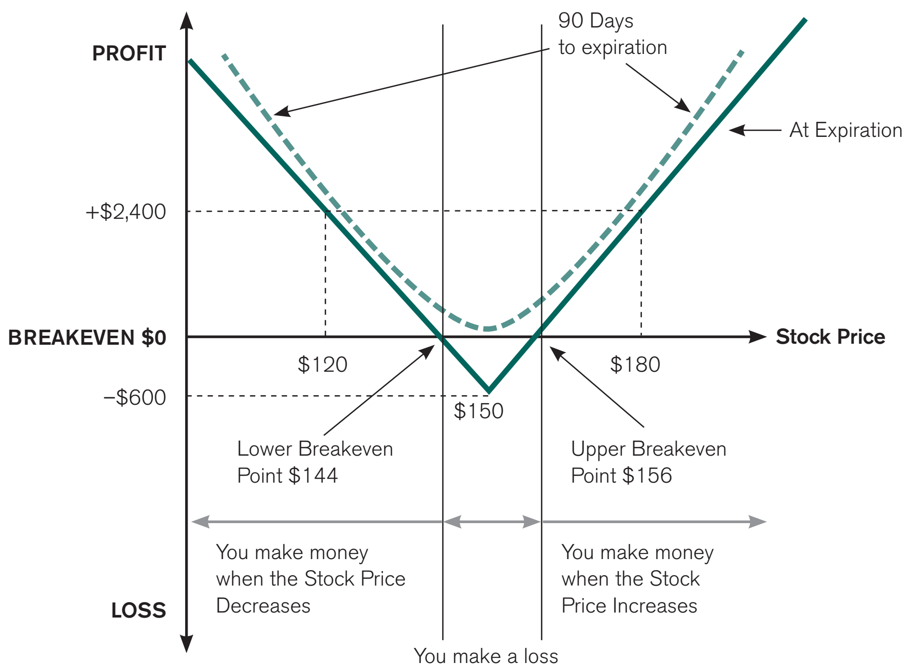


Chart 11: GS Straddle:
Buy GS Dec 150 Call @ $3 and Buy GS Dec 150 Put @$3



You can see from the Chart 11 that in a Straddle, you can make unlimited profits when the stock price increases way beyond the Strike Price (i.e. $150) as well as make unlimited profits when the stock price decreases way below the Strike Price (i.e. $150).

If the stock price should increase, the value of your Calls will increase dramatically, while the loss of your Puts will only be limited. So, the net result will be a profit. At the same time, if the stock price plunges, the value of your Puts will increase significantly, while the loss of your Calls will be limited. Again, this gives you a nice profit.

Wow! That sounds great you may say. So what is the catch?

Well, the catch is that the stock must move sufficiently either up or down. If the stock price has low volatility and does not move beyond the upper or lower breakeven points, you will make a loss! It is also twice more expensive to create a Straddle than to just buy a Call or a Put since you are now paying a double premium.

You can see that because of this double premium, the breakeven point is a lot higher as compared to buying straight Call & a lot lower when compared to buying a straight Put.

A Straddle's Total Investment (Maximum Risk)

When you create a Straddle, your total investment would include the; Call Option Premium + Put Option Premium.

In this case, your total investment would be:

Call Option Premium (1 contract) + Put Premium (1 contract)

= ($3 x 100 Options) + ($3 x 100 Options) = $600

Thus from Chart 11, you can see that $600 is the maximum amount you could lose on this trade. If the stock price does not increase or decrease beyond the breakeven points and neither of your Call or Put options are 'In the Money', then you will lose $600 if you let both options expire worthless.

However in reality, no investor would ever let this happen. You would normally sell your options way before the expiration date to cut your losses and you will lose only a fraction of your total investment.

A Straddle's Breakeven Points

So, how much must the stock move up before you start making money? If you hold your Options until expiration (as shown in the red line), then the upper breakeven point is the 'Strike Price + Call Premium + Put Premium'. The stock price must move enough to cover the cost of your double premium before you make a profit at expiration!

In this case, the upper breakeven point is $150 + $3 + $3 = $156. So, GS's stock price must move beyond $156 for you to make money.

How much must the stock move down for your trade to be profitable? If you hold your options to expiration (the red line), the lower breakeven point is the 'Strike Price – Call Premium – Put Premium'.

In this example, the Lower Breakeven point is $150 -$3-$3 = $144. So GS's stock price must fall below $144, for you to make money.

These breakeven points are only valid if you hold your Options until expiration! In reality, we will sell our Options once we hit our profit targets, usually way before expiration date. The curved dotted line is the Risk-return profile when the Straddle is 90 days to expiration. As long as you sell your options early (at least > 30 days to expiration), then you can make profits even if the stock does not move beyond or below the breakeven points!

How Much Profits Can You Make?

At expiration, Goldman Sach's stock price actually rocketed to $180 per share! So how much would you have made on your Straddle?

First, notice that your Calls are now 'In the Money' and have increased in value and your Puts are 'Out of the Money' and have decreased in value!

Since the Strike Price is $150, you could exercise your Calls and buy 100 shares of GS at $150 and sell it for $180. So the intrinsic value of your Calls is now $30!

How about your Puts? Your Puts are now 'Out of the Money' and have no intrinsic value! At expiration, they are worthless! You sell your 100 calls @ $30, so you collect = $3,000. Your investment was the double premium = $600. So, your profit is $3,000 – $600 = $2,400! (a 400% return!)

Your profit could be more as you would sell your Options 30 days before expiration, when you will also have time value left in your options!

To summarize,
Your Maximum risk (loss) = Call Premium + Put Premium
(i.e. ($3 + $3) x 100 shares = $600)

Upper Breakeven Point (at expiration)
= Strike Price + Call Premium + Put Premium
(i.e. $150 + $3 + $3 = $156)

Lower Breakeven Point (at expiration)
= Strike Price – Call Premium – Put Premium
(i.e. $150 – $3 – $3 = $144)

Your Profit When Stock Moves Up (at Expiration)
= Stock Price – Strike Price – Call Premium – Put Premium
i.e. ($180 – $150 – $3 – $3) x 100 = $2,400

Your Profit When Stock Moves Down (at Expiration)
= Strike Price – Stock Price – Call Premium – Put Premium
i.e. ($150 – $120 – $3 – $3) x 100 = $2,400

Strategies In Placing Straddles

I find that the best time to use a Straddle is when I am confident that the price of a stock will swing significantly upwards or downwards as a result of a particular news event. The biggest mover of a stock price is by far the release of its earnings report, which happens every quarter. If the stock has a history of reacting wildly to earnings release, it would be a good idea to place a Straddle more than 3-4 weeks before the actual announcement date.

Another big market moving event is when the US Federal Reserve (FED) announces its plans for interest rates. When inflation is a concern, the FED will tend to raise interest rates. This action always causes the stock market to go into a tailspin. The last time the FED increased interest rates, the S&P 500 went into a 3-month decline and lost more than 70 points! However, when the FED decides to cut interest rates, the market will always rally strongly!

FED Increases Interest Rates ⟶ Stocks Market Declines

FED Cuts Interest Rates ⟶ Stock Market Ralies

The FED usually announces its policies during its regular FOMC (Federal Open Market Committee) meetings that are held at least 8 times a year. By placing Straddles on the S&P 500 (Symbol: SPX) 2-3 weeks before FOMC meetings, I am able to make nice profits when the markets move. You can get a list of the upcoming FOMC meeting dates at www.federalreserve.gov/FOMC. Below shows an extract from the website on the tentative meetings dates in 2007.

Chart 12: Screen capture from www.federalreserve.gov

2007					
January 30/31	February	March 20/21	April	May 9	June 27/28
July	August 7	September 18	October 30/31	November	December 11

Minutes are released at 2:00 p.m. (eastern time) unless otherwise noted.

Note: Each meeting date is tentative until confirmed at the meeting immediately preceding it.

Note: A two-day meeting is scheduled for January 29-30, 2008 (Tuesday-Wednesday). Each meeting date is tentative until confirmed at the meeting immediately preceding it.

However, before you go out and start placing Straddles on any stock you see, you have to ensure that the stock fulfills two very important criteria:

1. The Stock Should Have A High Beta

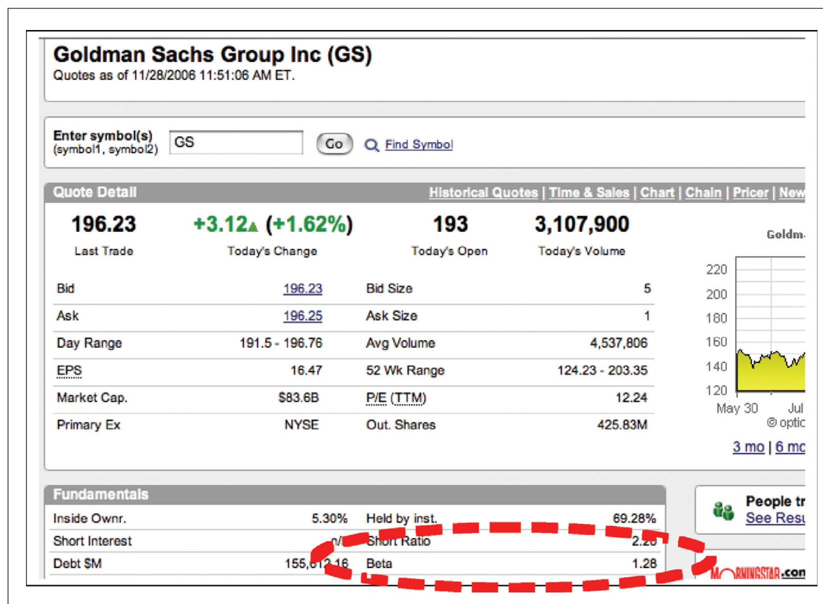
One way of telling how much a stock's price will react to market news is to look at the Stock's Beta. Beta is a measure of how sensitive a stock is to market movements.

A Beta of '1' means that the stock tends to moves in line with the overall market (the indexes). A stock that has a Beta of greater than '1' is more volatile than the overall market. So a Beta of '1.5' means that the stock is 50% more volatile than the market. You will want to ensure that the stock you place a Straddle on has a high Beta (at least > 1).

In this way, there is a greater chance that any kind of market news will cause the stock price to move significantly. You can find out a stock's Beta quite easily from the 'quotes page' on all online brokers. Below is an extract from the 'quotes page' from optionsxpress.com which shows Goldman Sachs (GS) having a Beta of '1.28'.

Chart 13: Beta of Goldman Sachs Group (GS)

Screen capture from www.optionsexpress.com



2. Buy Options only When the Stock has Low Current Volatility

Remember that we should always buy Options (especially Straddles) when the stock's volatility is low and when they are relatively cheaper. Since Straddles require you to pay a double premium, you would ONLY want to buy them when they are as cheap as possible.

This is why I like to buy Straddles 2–3 weeks before a potential market-moving event (e.g. earnings announcement, FOMC meeting etc…). The closer you get to the news event, the more volatile the stock price will get, the greater the volatility and the more expensive the options will be. By buying the options early, you get the lowest possible price. The great news is that when you move closer to the news event, the increased volatility in the stock (as there is greater interest in the stock) will increase the price of your options, earning you profits along the way!

Again, you can check the stock's relative volatility by applying 'Bollinger Band Studies' to the stock's price chart.

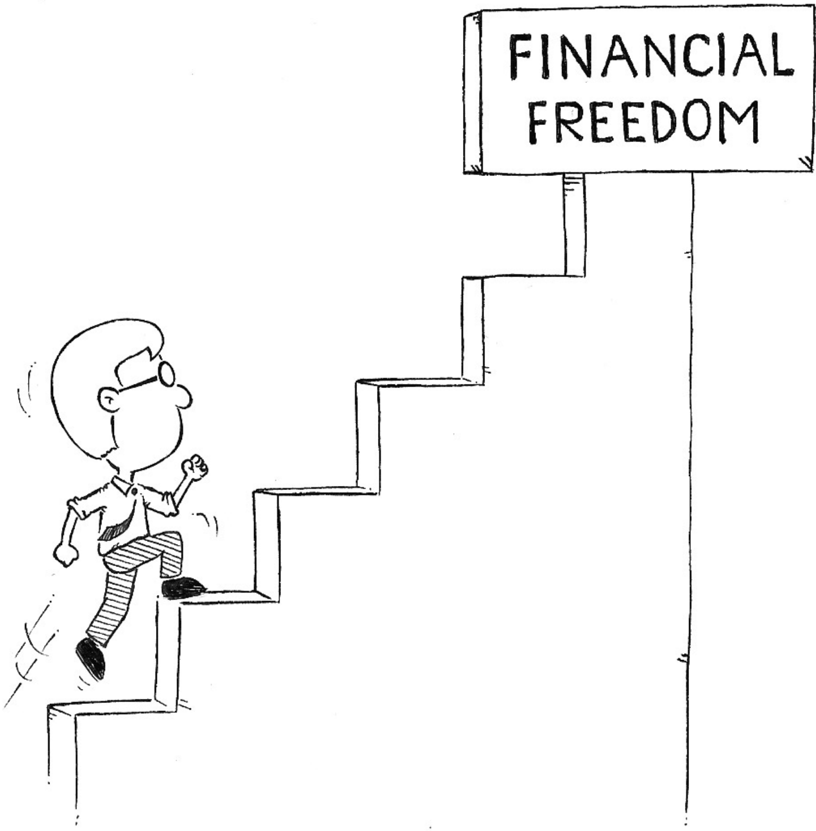
This concludes your learning on how to use Options trading as a powerful leverage tool to your investment strategies. There are many more advanced Options strategies out there. My advice to you is not to learn every single strategy at the beginning or you are going to feel overwhelmed. By attempting to 'test' and use every single strategy, you will end up as a master of none.

Most successful investors I know tend to focus only on one or two techniques and become experts on it. For example, some traders focus only on using Calls on Momentum Stock. Others search for bearish stocks to buy Puts on. Ultimately, you need to find a strategy which best suits your personality.

Happy Investing!

9

Your Next Step to Financial Freedom


FINANCIAL
FREEDOM

chapter 9

Your Next Step to Financial Freedom

Welcome to the final chapter! In the last two hundred odd pages, you have learnt some of the most powerful strategies and closely guarded secrets that millionaire investors use to make money from the markets consistently.

I can understand that learning all this information for the first time can be pretty challenging, especially if you are a beginner. If you are feeling overwhelmed or even slightly confused over some of the concepts taught, don't worry! It is only natural. I remember that when I first learnt about 'moving averages', 'stochastics' and 'Calls & Puts', I had a glazed look in my eyes and my head was spinning from confusion. I was thinking to myself, 'how can I ever remember all this stuff, much less apply them?'

Well, thank goodness I did not choose to say, 'I can never do it!' Instead, I told myself that I would do whatever it takes to master this essential life skill. I knew that even if I had to read the materials over ten times and spend months practicing what I had learnt, it would be worth it. It is because of that choice I made in the past that today, I am able to create an additional source of income and wealth that others only dream of.

Remember that nothing great ever comes easy. If investing was that easy, then everybody would quit their jobs and spend their free time making millions from the markets. The reality is that most people lack the will power and self-confidence to master anything new. The moment things get slightly challenging; these losers will start giving themselves excuses and give up.

The great news is that learning how to invest is like learning how to drive a car or learning how to swim. When you first start, it always seems difficult and even scary at times. However, with enough persistence and practice, you will eventually master it. And once you get the hang of it, it will seem so natural and easy! And just like driving and swimming, the skill of investing is something that will stay with you for the rest of your life.

Your Education Has Just Begun

I also want you to know that reading this last chapter does not mark the end of your training to become a great investor, it only marks the beginning!

Just like in any career you pursue after 16 years of education, the most important lessons will not come from just reading this book, but will come from the actual experiencing of researching for stocks, studying charts and clicking the buy and sell button on your online brokerage account.

The concepts and strategies you have learnt in this book are only the tip of the iceberg. There is so much more you can learn and have to learn. If you really want to become a great investor, I suggest that you attend a credible course on investing where you will have the chance to see live demonstrations and be personally coached by people who will help you every step of the way.

In our live Wealth Academy™ Seminars & Mentorship programs, Conrad and I will teach you many more powerful concepts and in much greater depth as well as show you exactly how to apply them one step at a time. If you want to join us in our next seminar, you can go to www.akltg.com to find out more or give us a call at 65-62740105 and speak to any of our customer service officers.

I also recommend that you continue to expand your knowledge of investing by reading more great investing books (refer to the reference books listed at the end of this book) and visiting some really great investment websites that will give you great new insights and content-rich information. I highly suggest that you go to www.wealthacademyinvestor.com and www.investopedia.com for some great investing tips!

If you are wondering why there is so much to learn in order to invest successfully, think about it this way. People go to university between a period of four to six years to learn the knowledge and skills required for a career that would give them a starting pay of S$2,000–S$3,000 a month. If you want to learn how to successfully make US$2,000–US$7,000 a month as an investor, don't you think that many hours of learning and practice is necessary as well?

Make It A Must to Succeed And You Will

I believe that you have picked up this book and have spent the time to read it all the way to the last chapter because you have a goal of increasing your income and wealth. However, you must ask yourself if your financial goals are a mere 'WISH' or a definite 'MUST'. I have found through working with over 380,000 people in the last 10 years that less than 5% of people make it a 'MUST' to succeed. Sadly, the 95% of the majority only 'WISH' to achieve financial freedom. What is the difference between these two attitudes?

When you make it a 'MUST' for yourself to become rich, you will be 100% focused and committed in making it happen. It will become a priority in your life and you would not let anyone or anything distract you. When it is 'MUST' for you to become a successful investor, you will do whatever it takes to succeed. You will be willing to spend the hours reading up on areas you do not understand, you will proactively find answers to your questions and you will be willing to learn from your mistakes and losses. When you have such a high level of conviction, success is always a guarantee.

However, when your goals are merely a weak 'WISH', you will tend to only give things a 'try' and take action only when it is conveniently within your comfort zone. When things start to get challenging, 95% of the people will start giving themselves excuses like 'I don't have the time', 'this is not for me', 'it is too much work', ' I am lousy at numbers' and the list goes on. Sure enough, they will soon quit and pursue the next get-rich-quick scheme (which does not exist).

I believe that all these powerful strategies you have learnt are extremely valuable but they will not work unless you have the commitment and drive within you to master and apply them. Like any other profession, becoming a successful investor takes a lot of hard work. You must be willing to pay the price. The great news is that the rewards you receive will be amazing!

Run Your Investments Like a Business

I have found that people who have made money consistently through their investments are able to do so because they treat it with same seriousness as they would in building a business or a second career.

If you treat investing as just a 'by-the-way' activity that you spend time on now and then, you will never be able to succeed. So, how can you run your investing activity professionally like a home business? Here are a few tips I use…

1. Decide On The Investment Strategies You Will Use

Just as an entrepreneur has to decide on the mix of products that his business will sell, you have to decide on the type of investment strategies you will use to generate the profits that you aim for. You also have to decide how you are going to allocate your investment funds between them.

In this book, you have learnt a whole range of investing strategies to make money. Some of them are short-term and some of them are long-term. Some of them require daily monitoring while others require monthly monitoring.

The kind of strategies you should employ depends on your targeted rate of return as well as the amount of time you have to spend. For example, being a full time trader who is able to monitor the markets for 5-6 hours a day, Conrad focuses 100% of his money into very short-term momentum trades that make him quick gains within a few days. Because of his smaller investment capital (which he first started with), he solely uses Call & Put Options that give him the highest possible return of 100%-200% on his money. His strength in Technical analysis gives him an advantage in picking the best momentum trades.

As a person who has full time businesses to run and relatively less time to trade on a daily basis, I (Adam Khoo) allocate 80% of my money into medium-term value stocks as well as buying ETFs that track the overall market and its sectors. My strength in fundamental analysis and business strategy also gives me an advantage as a value investor. I would only focus the remaining 20% of my funds into short-term momentum trades to give my returns an added boost.

Whatever investment you decide to use, always remember that you need to diversify your money adequately into at least 8-10 different stocks or options at any one time. No matter how much research you do and no matter how good a company's stock can look, things can turn against you with a single piece of negative financial news.

Be prepared to make losses on a few trades, it is only natural. However, if you stick to the rules and cut your losses, the profits you make on your winning trades would be enough to build a small fortune.

2. Find A Good Online Broker

Just as a good business requires reliable and cost effective suppliers, you too must choose a good online broker that will help you to access the markets and provide you with the right research tools to make the best investment decisions at a reasonable cost. Some of the largest online brokers include: www.optionsxpress.com, www.e-trade.com, www.interactivebrokers.com and www.thinkorswim.com

Table 1: An Example of an Online Broker

Screen capture from www.optionsxpress.com

There are three main factors you should look at in selecting an online broker:

a. Financial Stability
This is of course the most important factor of all. You will want to make sure that the broker you use is financially stable and will not go bust the next day. Financially strong brokers like www.optionsxpress.com and www.interactivebrokers.com will have high Standard & Poor's Credit Ratings (above BBB) and each individual's account will also be insured against losses of up to US$30m.

b. Competitive Commission Rates
In order to keep your costs to a minimal and your profits to a maximum, you will also want to use brokers that charge competitive commission rates. You can easily compare rates across brokers by visiting their respective websites.

c. Research & Trading Tools
A good broker is also one that will provide you the very best research and trading tools. Ensure that the broker you choose provides live streaming charts & quotes, adequate technical analysis software, automated trading tools, efficient customer service and research reports. Although www.optionsxpress.com has slightly higher commissions then www.interactivebrokers.com, the superior tools the site offers makes it worth the extra cost.

3. Have An Investing Plan

Every successful business is built upon the execution of a well thought of business plan. Similarly, you need to have a winning investment plan for each of the strategies you are using. You should create different investment plans for Index investments (ETFs), momentum investments and value investments. You should also have a plan for the trading of Call Options and Put Options (should you choose to use Options).

Your investment plan should specify all the criteria that must be met before you make a 'buy' and the conditions in which you will sell. Refer back to the earlier chapters on the conditions for buying and selling. A sample of the investment plan for 'Value Stocks' is shown on the next page.

Table 2: Sample Value Stock Investment Plan

Value Stock Investment Plan

Company Name: ______________________ Date of Analysis: __________

Stock Code: ____

Stock Exchange: ____

Rating: ____

1. History of Consistently Increasing EPS, Sales & Cash Flow	Yes	No
a. EPS has increased consistently over 5 years?	☐	☐
b. Sales has increased consistently over 5 years?	☐	☐
c. Cash Flow has increased consistently over 5 years?	☐	☐
d. What is the historical/projected EPS growth rate? _____________ %		

2. Sustainable Competitive Advantage	Yes	No
a. The company has a sustainable competitive advantage?	☐	☐

3. Future Growth Drivers	Yes	No
a. The company has future growth drivers in place?	☐	☐

4. Conservative Debt	Yes	No
a. The company has Long Term Debt $<$ 3 x Net profit?	☐	☐
b. Long-Term Debt is $ _____________		
c. Net Profit is $ _____________		

5. High & Consistent ROE and ROA	Yes	No
a. The company has ROE $>$ 12-15% over 5 years?	☐	☐
b. The company has ROA $>$ 7% over 5 years?	☐	☐

6. Low CAPEX for Maintenance of Current Operations?	Yes	No
a. The business requires low CAPEX for maintenance of Current operations?	☐	☐

7. Management is Holding/Buying the Stock Yes ☐ No ☐

a. Key Management has not been selling large Proportion of company stock?

8. The Stock Price is Selling at a Discount (High Margin of Safety)

a. Current operating cash flow/EPS $ ____________

b. Projected Cash Flow growth rate/EPS $ ____________

c. Number of shares outstanding ____________

d. Intrinsic Value $ ____________ Yes ☐ No ☐

e. Share price is below intrinsic value?

9. Stock Price is Consolidating or on an Uptrend Yes ☐ No ☐

a. Stock price is consolidating/on uptrend

Rating System
**** : Strong company selling at a high discount
*** : Strong company selling at a moderate discount
** : Strong company overvalued- Keep on Watchlist
* : Fundamental criteria failed.

4. Keep Good Accounts of Profits & Losses

It is also very important for you to keep a record of the market value of your investments, the cost of purchase and the profits and losses you have made over time. You should constantly update this profit & loss statement at least once a month.

Keeping an updated record will give you a good indication of how well your investments are performing and how close you are to your targeted rate of return. Using spreadsheet software like Microsoft Excel, you can easily construct a record of your portfolio value as shown below in Table 3:

Table 3: Profit & Loss Table for Your Portfolio

DANNY LEE'S PORTFOLIO										
VALUE STOCKS	DATE BOUGHT	QUANTITY BOUGHT	BUY PRICE	COMMISSION	TOTAL INVESTMENT	CURRENT PRICE	CURRENT VALUE	PROFIT/ LOSS	TOTAL PROFIT/ LOSS	Total Return (%)
Anheuser-Busch	25/02/06	1,500.00	$ 42.95	$ 75.00	$ 64,500.00	$ 50.83	$ 76,245.00	$ 11,745.00	$ 11,745.00	18.21%
					$ -		$ -	$ -		
Wal-Mart Stores	20/02/06	1,500.00	$ 45.33	$ 79.00	$ 68,074.00	$ 47.43	$ 71,145.00	$ 3,071.00	$ 3,071.00	4.51%
Total:				$ 154.00	$ 132,574.00		$ 147,390.00	$ 14,816.00	$ 14,816.00	10.05%
MOMENTUM STOCKS	DATE BOUGHT	QUANTITY BOUGHT	BUY PRICE	COMMISSION	TOTAL INVESTMENT	CURRENT PRICE	CURRENT VALUE	Return ($)	TOTAL PROFIT/ LOSS	Total Return (%)
In-Phonic	15/06/06	1,640.00	$ 6.10	$ 82.00	$ 10,086.00	$ 13.83	$ 22,681.20	$ 12,595.20	$ 12,595.20	124.88%
								$ -		
Yahoo!	3-Oct-2006	2,500.00	$ 23.14	$ 125.00	$ 57,975.00	$ 28.21	$ 70,525.00	$ 12,550.00	$ 12,582.50	21.70%
								$ 32.50		
Total:				$ 207.00	$ 68,061.00		$ 93,206.20	$ 25,177.70	$ 25,177.70	36.99%
MARKET ETFs	DATE BOUGHT	QUANTITY BOUGHT	BUY PRICE	COMMISSION	TOTAL INVESTMENT	CURRENT PRICE	CURRENT VALUE	Return ($)	TOTAL PROFIT/ LOSS	Total Return (%)
SPY	30/01/06	1,000.00	126.00	50.00	126,050.00	142.05	142,050.00	16,000.00		12.69%
DIA	30/01/06	1,000.00	107.00	50.00	107,050.00	125.00	125,000.00	17,950.00		16.77%
					0.00		0.00	0.00		#DIV/0!
				100.00	233,100.00		267,050.00	33,950.00		14.56%

5. Keep A Journal Of Your Transactions

As a successful investor, you will also need to keep a record of every single transaction you make. Every time you buy a security, you should record down the date of the transaction, the quantity purchased and the total cost. Whenever you sell a security, you need to record the selling price and the profit or loss from the sale.

Keeping a journal of your trades will allow you to study both your winning trades and your losing ones. This is one of the best ways to identify the mistakes you have made in the past and to learn from them. Table 4 shows you an example of how I record my transactions on a Microsoft Excel Spreadsheet.

Table 4: A Journal of Transactions

US VALUE STOCK TRANSACTIONS					
Date	Stock	Details	Amount	Profit/ Loss	Total Profit/ Loss
10-Sep-2005	AIG	Buy 273 at $54.07	$14,761.00		
5-Jan-2005	AIG	Sell 173 at $68.72	$11,889.00	$2,534.00	$2,534.00
18-Jan-2006	BUD	Buy 100 at $42.02	$4,202.00		
18-Jan-2006	TYC	Buy 200 at $26.24	$5,248.00		
20-Jan-2006	WMT	Buy 60 at US$45.53	$2,731.80		
21-Mar-2006	PFE	Buy 18 at US$26.50	$477.00		
4-Nov-2006	PFE	Buy 100 at US$24.70	$2,470.00		
18-Apr-2006	AIG	Buy 50 at US$62.81	3,140.50		
22-Apr-2006	ITRI	Buy at 10 at US$65.92	$650.92		
23-Apr-2006	OVTI	Buy 20 at US$29.73	$594.60		
24-Apr-2006	SBUX	Buy at 20 at US$39.17	$783.40		
25-Apr-2006	GOL	Buy at 20 at US$35.56	$731.20		
26-Apr-2006	CRDN	Buy at 10 at US$55.02	$550.02		
27-Apr-2006	SCSS	Buy at 15 at US$41.55	$623.25		
29-Apr-2006	SBUX	Sell 20 at US$37.37	$747.40	-$36.00	2,498.00
30-Apr-2006	CRDB	Sell 10 at US$50.50	$505.00	-$45.02	$2,452.98
5-Mar-2006	GRMN	Buy at 10 at US$95.94	$950.90		
5-Mar-2006	DXPE	Buy at 10 at US$51.65	$510.65		
5-Mar-2006	GRMN Call .	Buy at 100 at US$2.61	$261.00		

There is Magic in Action!

On a final note, I want to strongly urge you to take all this knowledge you have gained over the last few days and start taking ACTION. Start by saving 10–20% of your income every month, open an account with an online stock broker (it is free), begin researching the financial sites we have discussed and start putting stocks through the different selection processes you have learnt!

I also strongly suggest that you use virtual money to invest for at least three to six months before using real money. Most online broker sites like www.optionsxpress.com allows you to create a 'virtual trading account' where you will be allocated US$100,000–US$300,000 of virtual money to invest and trade in. Using virtual money will allow you to test out these strategies and to get familiar with using the trading platform.

Only when you are able to make consistent profits for over 3–6 months should you use your hard-earned money. Just as pilots go through flight simulation training before they are allowed to fly a real plane, you should also put yourself through investing simulation.

Remember that knowledge is NOT power. If knowledge was power, then all the libraries in the world would be heavily guarded by the strongest of armies. Instead, knowledge is only potential power. It is the combination of knowledge and consistent ACTION that generates tremendous power.

It is when you start taking action immediately, that you will start the process of moving towards a more abundant future. Finally, I would like to wish you all the very best in your quest for wealth. It is not an easy journey but I know that your strong desire and self belief will see you through the challenging times.

I hope that you will write to me or that if we will meet one day at a seminar you will tell me your success story.

Until then, be sure to live your dreams!

Adam Khoo and Conrad Lim

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