Chapter 6:
KYY’s Golden Rule and Complementary Guidelines

6.1 KYY's Golden Rule:

"*Try to find a business that you can understand, that's not particularly complicated, that has a successful long-term track record, makes an attractive profit and can grow over time.*"

Bill Ackman

In this chapter, we will discuss the golden rule, and complementary guidelines developed by Koon after refining his investing philosophy for three decades. The method has been proved profitable and sound through numerous tests in sideways, bull and bear markets. It has helped him build massive wealth so he can donate more and more for good causes. In addition, the method has benefitted many of his disciples.

The method is very simple, and does not require one to have an MBA or a PhD in finance to achieve a good result. Only the discipline to follow his golden rules closely and complementary guidelines, and the ability to control emotions are the quality needed to be a successful investor in Malaysia stock market.

6.1.1 Buy Stocks with Profit Growth Potential, which Have Delivered Two Consecutive Quarters of Increasing Earnings

"*Only by growing better can a company be sure of not growing worse*."

Philip Fisher

No one likes to lose money, be it in stock investment, forex trading, or house flipping. The anguish we feel is more intense when something is lost than the happiness we get when something of equal value is gained. The only way to make ourselves happy is to win. However, we could hardly win if we bet on stocks that reporting losses continuously. A business is not worth a brass farthing if it is unable to generate profits for its shareholders. Our wealth would be diminished if we bet on companies with no profit growth potential.

When analysing a business, we must always make sure that the company has tremendous profit (and revenue) growth potential, and has delivered two consecutive quarters of increasing earnings before placing our wager. From Koon's study, profit growth is the most powerful catalyst that moves the needle of a stock. A company with terrific earnings growth potential, which has delivered two consecutive quarters of increasing earnings, will always be the next booming stock. The two consecutive quarters of increased profits is an indicator showing the company is very likely on the right track of growth. His recent investments in Supermax (which rocketed 900% from 2009 to 2010), Latitude (which soared 1300% from 2012 to 2016), V.S. Industry (which climbed up 500% from 2014 to 2015), Poh Huat and LiiHen (each appreciated 300% from 2014 to 2015) are some good examples. They did not just protect his portfolio from the risk of capital loss, but they also helped him grow his wealth substantially.

The task of finding a company with profit growth potential may, at the start, seem challenging for many novice investors with weak business acumen, but if we persist in our quest for the prospect by asking ourselves if the future profits of the business will be higher than its recent profits and past profits, we should be able to find the answer. The process will prompt us to search for catalysts embedded in the business, and to identify the competitive advantages the company possesses, and with which we will be able to make an informed judgement, and enjoy a higher probability of success.

Catalysts that promote the profit growth of a business can be existed in many different forms, which include, but are not limited to

- Expansion of manufacturing capacity
- Extension and expansion of product line
- Improving efficiency
- Increasing product price
- Higher sales volume
- Increasing backlog
- Higher product demand than supply
- Increasing market share
- Decrease in cost of sales
- Improving profit margins
- Favourable foreign exchange rates
- Invention of new innovative product
- Receipt of concession contract
- Receipt of award for infrastructure development
- Receipt of casino operating license
- Discovery of new oil field
- Significant change in currency value
- Tax incentives from the government
- Restructuring of business or organisation
- Transformation of business model
- Change of management

All these catalysts will generally contribute positively to the bottom line of a business. Nevertheless, we should not take them for granted. According to Koon, based on his experience in the construction industry, not all contracts are profitable. Cost overruns in megaprojects can ruin even a solid company. Further, higher sales volume sometimes may not necessary be translated into higher profits.

Competitive advantages that indirectly help increasing profits, on the other hand, can be found in different forms, which include, but are not limited to

- Strong brand identity
- High switching costs
- Proprietary learning curve
- Proprietary product differences

- Proprietary low-cost product design
- Government policy, licenses and regulatory approvals
- High capital requirements
- Economies of scale
- Cost competitive advantage
- Technical know-how
- Niche strategy
- Unique corporate structure
- Unique company culture
- Strong geographical advantage
- Impressive distribution network
- A strong company reputation
- Strong network effect

Whilst these advantages allow the company to outperform its peers, we should not rely solely on the company’s competitive advantage. Not all competitive advantages are created equal in terms of strength and sustainability. Some seemingly profitable businesses might end up losing substantial market share if the companies are unable to retain their clients. Companies with strong management teams may also end up losing money when they lose their magic touch.

After identifying the catalyst and/or competitive advantage, our next job is to evaluate the predictability of the company’s future profits, and the consistency of its profit growth. To begin with, we need to estimate the stream of revenues the company can expect to achieve in the next few quarters through the projects they are working on, outstanding order book or backlogs, contract awards expected to receive, and market demand. Subsequently, we need to determine profit margin trend of the firm over last few quarters, and apply the figure on the estimation of its future profits and profit growth. The effort of ascertaining the sustainability of profit growth is so important that it will enable us to deploy our strategies effectively. And we would be rewarded handsomely if we perform the analysis well.

Please note that, whilst earnings trend information is a good indicator of an improving situation, it does not provide us any guarantee that the future earnings of the stock will be higher. Things always change, and the only thing that does not change is change itself. Therefore, we need to monitor its business continuously. And no matter how good the current quarterly earnings is, compared to the quarterly earnings a year ago, it does not provide us any assurance that the stock price will be going up tomorrow or next week. But our wealth will grow considerably when the market recognises its value one day.

Also, we need to take note that a surge in earnings could be due to seasonality factor, or one-time gains from the sale of some assets. Projecting the immediate past increasing earnings into the future, like what financial analysts normally do, without looking at the profits from business perspective and sustainability viewpoint is a dangerous technique. If we buy the stock blindly, our portfolios would wind up badly wounded when the next quarter's profits fall.

6.2 Complementary Guidelines:

"*We don't get into things we don't understand. We buy very few things, but we buy very big positions. Know what you own, own a few and buy a lot.*"

Warren Buffett

"*Soros has taught me that when you have tremendous conviction on a trade, you have to go for the jugular. It takes courage to be a pig. It takes courage to ride a profit with huge leverage.*"

Stanley Druckenmiller

Buying profitable stocks with bright earnings growth prospect helps protecting the value of our capital, buying and selling them at the right prices and at the right times help reaching our destination faster. Therefore, the complimentary guidelines are as important as his golden rule.

6.2.1 Only Buy the Stocks that You Can Understand Their Businesses

Buying stocks is no different to acquiring companies, except that stocks can be purchased in a small quantity, and are liquid, tradable securities. Just like every acquirer, we should only buy what we can understand, and we must analyse the business of a company before buying its shares. Buying a stock without understanding the business of the stock is akin to throwing our money in a poker pot without reading our cards. How could we play the game with conviction, know the odds, and deploy a winning strategy if we do not look at the cards? Moreover, failing to perform due diligence will risk our hard-earned money in the bet. Our destination would be permanently out of sight if we hold a wrong perception since the very beginning of our investment journey.

In order to get a reasonable understanding of a business, a few important questions we should ask ourselves before committing our hard-earned money are

- What is the company making or selling?
- How its revenue and profits are derived?
- Do the company's sales and profits grow steadily?
- Is the profit margin of the firm well maintained or growing progressively?
- How the market and industry work?
- How have its top line and bottom fared in comparison to its peers?
- What are the business models the organisation adopts to maximise its sales and earnings?
- Does it have any competitive advantages?
- Who are the key management people? Are they competent managers?
- Does the management team have a proven track record of success?

- Is the management team committed to the success of the company?
- Is the compensation level of the CEO reasonable?
- Is the management team receiving staggering paycheques whilst delivering mediocre results?
- Do the management own substantial stakes in the company?
- Is the communication between management and shareholders clear?
- Has the company been generously rewarding its shareholders?
- Has the company repurchased its own stock from the market (at the prices below its intrinsic value) over the past two years?
- Is the company efficient in utilising its resources?
- Does the firm have an ability to service its debt during good time and bad time?

The answers to all these questions will tell us a lot about the company's future. The future of the company is likely to be bleak, and the potential growth of the business is almost none if the negative answers far outstrip the positive answers. With the effort devoted to understanding each of the businesses, we stand a higher chance of finding a fabulous investment, even though terrific companies or outstanding management teams are hard to come by.

Please note that, whilst the businesses and the corporate structures of most companies are easy to understand, some are pretty complicated for common men, especially novice investors, to understand well. If you happen to come across any company that is too hard for you to understand its business, just give it a miss and move on to the next one.

6.2.2 Make Sure that the Companies have A Good Track Record of Making Money

The worst investment mistake people always make is buying lousy companies that lose money years after years. The only expectation they can get is the share prices go lower and lower. Eventually they will be doomed to disappointment. How can anyone get a high investment return on a lousy company, which has already been producing abysmal performance even before the investment was made? To protect ourselves from being drawn into the vortex of investment black hole, we must shun every poorly run company (with a long streak of appalling performance) at all costs, no matter how cheap the stock is. Only buy stocks that are exceptionally good and with profit growth potential, not lacklustre.

According to Koon, from his years of observation on the stocks listed in Bursa Malaysia, good companies with an excellent track record in business will continue to thrive, even during economic recessions. The combination of their high outstanding order-book, great business models, competent management teams, unique products, strong technological know-how, and excellent service provides them many unfair advantages that always keep their competitors at bay. Owning this type of companies does not only shield our portfolio from an abrupt fluctuation of the investment rate of return, it also safeguards our money from the risk of permanent loss. Therefore, this type of stocks is not cheap. As expected, their stock prices are also always on uptrend in tandem with the earnings of their businesses. The best time to collect them is when they are still flying under the radar of investment banks or mutual funds, during bear markets, or during panic sell-downs. If you have some money to spare, make sure that you grab them when the opportunity presents itself.

6.2.3 The Projected P/E Must Not Exceed 10

For novice investors without financial knowledge, projected P/E ratio, also known as projected price-to-earnings ratio, is one of the important basic metrics we should understand in order to value a stock. Amongst the basic metrics used by analysts to estimate the value of a stock, Koon believes projected P/E ratio is the best one. The reason: it is easy to use, simple, yet more practical than the other metrics such as price-to-book value (P/B) ratio, price-to-net-net working capital ratio (P/NNWC) ratio, price-to-sales (P/S) ratio, enterprise value-to-earnings before interest and tax (EV/EBIT) ratio, and etc.

In investment, the value of a business should not be determined based on the assets possessed by the firm, as some equipment, tools, goodwill, properties, and some current assets do not contribute much to the top line of the business. To make the matters worse, the cost of maintaining some of the assets may be higher than the revenue and profits they generate for the business. The maintenance expenses, coupled with depreciation, might eat into the bottom line if the assets do not help generating sufficient profit to offset the costs.

Further, the debt level of a company should not be overemphasised in business valuation. The risk of an investment is not solely determined by the debt level of the company. Many good investment opportunities would be overlooked if we set our barrier unreasonably high. According to Koon, when he started Mudajaya and Gamuda in 1966, before they were listed and became IJM Corporation Bhd, he had to borrow as much as possible to do business. If his companies' faithful investors had eschewed companies with debt, they would have missed out on the opportunities to prosper with him, wouldn't they? During his early days as construction contractors, he had great difficulty to borrow money because Banks would not accept bulldozers and other construction equipment as collaterals. They considered construction equipment unsafe, as they were movable assets. He did not have fixed assets, like land and office buildings at that time. He even had to mortgage his family homes to borrow more money to do business. Had he refused to mortgage his assets, he would have no chance to witness the businesses growing into multi-million and multi-billion ringgit companies.

In this section, we will go through the process of determining the projected P/E of a stock together. Let us begin with basic P/E concept by assuming that the current earnings-per-share (EPS) of a stock is Rm 1/share, and that we pay Rm 10 for each of the shares, the P/E would be 10. In other words, it would take the company about 10 years to earn us back the amount of money we have invested in the stock if its EPS is maintained at Rm 1/share for the next ten years. The return is estimated about 10% per year.

P/E = Price / EPS
= Rm 10 / Rm 1
= 10

Return = EPS / Price × 100%
= Rm 1 / Rm 10 × 100%
= 10%

However, for the same stock with the same amount of earnings, if we pay Rm 20 for each of the shares, the P/E would be 20. In other words, it would take the company 20 years to earn us back the amount of money we have invested in the stock. The return is estimated about 5% per year, which is far lower than that of the former.

P/E = Price / EPS
= Rm 20 / Rm 1
= 20

Return = EPS / Price × 100%
= Rm 1 / Rm 20 × 100%
= 5%

Please note that what we discussed just now was P/E concept, not projected P/E. To calculate the projected P/E of the stock, we need an estimated or projected EPS, instead of the recent past EPS. The recent past EPS does not tell us what will happen to the firm in the next twelve months or in the future. We cannot drive forward looking in the rear view mirror, even though the rear view mirror is clearer than the windscreen. The market does not care about the past EPS. Therefore, we can only use the information of the recent past quarters as a guidance. Ultimately our investment success still depends very much on our ability to accurately forecast the future earnings of the firm, and to find out how cheap the stock is, based on its current price. To precisely estimate the projected P/E of a company, we must be able to make an educated guess on its future EPS. Therefore, understanding the business of a company plays an important role in determining the earning power of a firm. We could not capture an opportunity timely when it arises, if we choose to ignore the business of a company.

To be a successful investor, we should aim at buying outstanding companies at wonderful prices. When we buy an excellent stock at a wonderful price, we get a lot more shares for our money, and our wealth will grow instantly. But done at a wrong price, our investment will sink like a stone. Each time when we overlook the value of a company or buy an overpriced stock, our investment return will be jeopardised. In order to achieve our goal faster, we should look for stocks with projected P/E lower than 10. The projected P/E multiple limit of 10 does not only help increasing our rate of investment return, it also allows us to close out without badly hurt if the tide turns against your original investment thesis or if your forecasted EPS gets terribly off, and help reducing some other unforeseen risks.

6.2.4 Use Leverage to Maximise Gain

Most of the eminent investors like Carl Icahn, George Soros, Robert Kiyosaki, Bill Gross, Stanley Druckenmiller, J. Paul Getty, used leverage to their edge. With leverage, they created more value for the money entrusted by their investors as well as built their own fortunes faster.

Koon always says margin loan is a very powerful wealth-building tool if we know how to use it to our advantage. For every additional Ringgit that we borrow to invest in the same stock, our capital gain will be twice higher than that using our original amount of capital when the prices of stocks we own appreciate. The magnifying effect of margin is very strong and clearly seen during bull markets. The subject of leverage is not a new topic in investment and business fields. In fact, it has been taught from way back in most of the business schools, where MBA students have been encouraged to take loan in the businesses they are dealing with to maximise their profits, if they are confident that their return would be much higher than the interest rate of the bank loan.

Whilst novice investors are not encouraged to use margin facility in the beginning stage of stock investment, he or she should learn how to use it through pre-mortem and subsequently review the process continuously. Once he or she has acquired sound investment knowledge, have gained sufficient experience to make high conviction investments, and have the ability to devise a winning strategy, he or she may start using leverage to his or her advantage.

If you are an experienced investor, and have an impressive track record of successful investments in the stock market, you should augment your capital with a margin loan to allow a bigger leap in your gain, and to enjoy a new breakthrough in your rate of return. At the interest rate of 4% per annum (charged by most of the investment banks in Malaysia currently), you can easily double your capital in less than two years from stock investment if you can achieve an annualised rate of return above 25%..

But mind you, leverage is a double-edge sword. It cuts both ways. Therefore, people who have poor record in investment should not use margin finance.

6.2.5 Do Not Borrow More than the Allowable Limit

For every Ringgit of cash that we possess, if we open a margin account with any of the investment banks, the bank will usually allow us to borrow another Ringgit to buy more stocks, and will subsequently use the stocks as collateral. For example, if we have say Rm 10,000, our investment bank will allow us to buy up to Rm 20,000 worth of shares (some banks allow up to a maximum of Rm 25,000 worth of shares).

However, it is not advisable to buy shares up to the maximum limit. In view of the rapid stock price fluctuation, if we buy up to the maximum limit, a margin call would be triggered when the prices of some stocks slide down the slope of despair. Despite having more winners in our portfolio, our effort might still end up down the drain if the losers kill our portfolio at a faster speed than the winners.

The most prudent way to manage the margin loan is to refrain from buying stocks up to the allowable limit. When the companies we own report increasing profits, their share prices and our collateral value will follow along; this will allow us to buy more shares. If you are tempted to buy with the increased collateral value, you may go ahead to do so, but do not borrow more than the allowable limit.

6.2.6 Sell Some that were Previously Bought Using Margin Loan

There are two circumstances we must sell the stocks we have previously bought using margin loan. The first situation is when the price of a stock surges to an unreasonably high level. When a company reports a sharp increase in profits, or when it reports some positive news and developments, the state of euphoria amongst investors and traders (when they rush to buy like crazy) will propel its share price upward. Nonetheless, based on Koon's study, no share can go up or come down for whatever reason. After reaching the first peak, the stock will be experiencing some consolidations when the euphoria begins to fade. If we previously bought the stock using margin loan, it is best to sell some of the shares, which has experienced a meteoric rise, near the top so that we can lock in some of our profits, pay back the margin loan, and have more fund to buy back the stock when it falls.

The second situation we should sell the stocks we have previously bought with margin loan is when they report poor earnings. Unlike U.S. stocks, companies in Malaysia are fairly young and unstable. Therefore, having a sustainable growth of profits is impossible for most of the companies. Their share prices tend to fluctuate dramatically when the companies report reduced profits, or when the supply of their products is more than the market demand. The moment we should start selling our shares is when they start reporting diminishing profits, or when the demand for their products has shown some deterioration signs. Stock prices will sink into red when the companies show poor performance. If we refuse to sell the losers and keep them longer in our portfolios, we do not just pay high amount of interest for the loan; our portfolios would also be vulnerable to margin calls.

6.2.7 Cut Loss will Limit Your Losses

Share prices seldom drop without a cause. There are many reasons why share prices decline. But two of the main causes, deemed important by the market, are lower profits (or financial loss), and higher supply than demand. The price of a stock will be losing its ground when its earnings begin to decelerate, or if the company reports financial losses. Similarly, the share price will take a nosedive if the industry in which the company get involved plunges into recession out of sudden due to supply glut problem.

As investors, we should learn to protect our capital, and do not ever allow our emotions to take over our logical thinking. Never fall in love with the stocks that we own. Do not ever assume that declining businesses will turn the corner soon. We must bite the bullet, and cut loss immediately when the tide turns against our original investment thesis. Do not let our bias (be it disposition effect bias, anchoring bias, or regret aversion bias), mistake, negligence, or false hope wipes off the gains we have garnered in the past from our investments in other stocks. When we weed out the losers early, our losses will be limited to a very small amount, and the major portion of our capital will be preserved and freed-up for other investment opportunities, and we live to fight another day. Also, by cutting our losses, and letting our winners run, we will win big when we win, and lose small when we lose.

6.2.8 Do Not Touch Down-trending Stocks

Novice investors have been warned by Koon many a time about the danger of buying down trending stocks or catching a falling knife, yet many of them pay no heed to his advice. As a result, they risk their hard-earned money to the permanent loss of capital when the company reports losses continuously, becomes a PN17 company, or files for bankruptcy protection. In the light of the consequences, we should avoid down-trending stocks at all costs.

When the price of a stock starts to fall, no one knows when the price will be bottoming out under such circumstances. Even a company, with a strong management team, that suffers temporary setback due to industry downturn, and that is less susceptible to bankruptcy risk will not be spared from the same fate. It will keep trending downward, and may fall below its underlying value to an irrational level. What is worse, the stock may even take a very long time to bounce back to the previous level, and may never recover at all. If we buy the stock on the way down, we are literally putting good money after bad, our capital would be locked in the stock for a long period of time, and we would suffer emotional pain when the price keeps hitting new lows. According to John Maynard Keynes, the market can stay irrational longer than we can stay solvent. Many good opportunities will just be passing us by when our capital is locked in the money-losing stock.

6.2.9 Wait Patiently to Catch the Big Fish

The secret of winning big in stock investment is of no difference with that of catching a big fish. Apart from using the right bait, it takes time and patience for the big fish to get hooked up. Likewise, in stock investment, we need to be patient to buy a stock below its fair price and to sell it for the highest gain.

Buying a stock at the right price, if not the lowest price, is so important that it provides us a margin of safety, which protects us from any unforeseen circumstances. Selling the stock at the highest price is equally important so we can maximise our gain, and it allows us to achieve our goal sooner. However, both processes require us to be patient.

Even if we managed to buy a stock at the best price, it does not mean that we will be able to rake in the highest profit from the investment. Koon has shown this concept to his followers many times that three people who begin a competition by buying the same stock at the same price can end up returning home with three different rates of return.

The first person, who shares the philosophy and strategy of traders by watching the stock market and chart diligently and trade frequently, realises his or her gain after the share price has gone up by 20%, and buy it back at a higher price when the subsequent buying signal is triggered again. The second person, who is a very well-informed professional investor, sells his or her stock after the share price has gone up by 100%. The third person, who is an entrepreneur and a superinvestor, holds on to his or her existing shares and keeps buying more shares using margin loan when the company continues to report growing profits. He or she only closes out his or her position when the company shows reduced earnings after riding the uptrend for years.

Amongst three investors, the first person can only expect a mediocre return. Every time when he or she trades, he or she does not only pay more commissions or transaction fees, he or she also fails to capitalise on the opportunity to ride the uptrend fully when the company keeps reporting increasing profits. The second investor, on the other hand, can expect a better rate of return as he or she holds the stock longer than the trader and sells it at a higher price. However, he or she refuses to buy back the stock after selling it, even though he or she realises later that the stock still has plenty of upside potential, as he or she becomes risk averse when the stock has appreciated considerably and is reluctant to admit his or her mistake by buying back the stock at a higher price. The third investor, who can wait patiently, will enjoy the highest gain as he or she possesses the composure to deal with stock price fluctuation and focuses mainly on the profit growth prospect of the company. To amplify his or her return, he or she uses the shares as collateral to buy more shares when the company continues to increase its profits.

6.2.10 Control Your Emotion of Fear, Greed, Ego and Overconfidence. Logical Thinking is the Key to Successful Investing

Investing is more of an art than a science. To be successful in investing, we need to be able to control our emotions all the time instead of having a PhD in economics or finance. If successful investing relies solely on strong financial knowledge, all economists, accountants and financial analysts would have become multimillionaires or superinvestors. Far from it. In fact, most of the funds underperform the index. Just like retail investors, most of the professional money managers also sell their stocks in the name of stop loss during major market crash. If everyone can think logically, the market would have been efficient all the while, all the shares would have been fully valued, and there would be no irrationally massive sell-offs during market declines. But, that is not the case.

People tend to get nervous during bear attack. When investors are in panic state, the news of market tumble or share price collapse will bypass the prefrontal cortex (an area where rational thoughts are conceived) since the forebrain section has been starved of oxygen and nutrient due to stress and overload. It will result in the signals be sent to medulla directly. The autonomic nervous system is subsequently triggered, and heuristics are then used to ease the cognitive load by disposing stocks on hand as fast as possible. This system is very helpful when a person is in an emergency state such as during fire breakout, explosion, earthquake and accident. The self-defence action, however, always leads to cognitive biases and disastrous investment outcomes. We have seen it many times that people who dumped stocks at nonsensically low prices during bear market regretted later when the prices of the stocks recovered, as far as panic selling is concerned. That is why even most wonderful stocks can be purchased at bargain prices during market crashes. If you can control your emotion you should know when to buy, and when to sell, and you should be able to make a heck of a lot of money at the big moments.

Another mistake investors usually make is defending the enormous ego within them, even if they have realised that their theses are wrong. Instead of selling the losers, they keep holding on to the stocks and witness the share prices tumble painfully. Likewise, they resist to buy back the winners they have disposed earlier on, anchor on the prices they have missed and watch the stocks keep climbing past their historic highs. In stock investment, humility is one of the most essential traits we should nurture within our inner self. We should strip off our armour against feeling shame, ready to admit our mistakes, refrain from blaming others and make a "U-turn" when we are on the opposite side of the right path so that we can maximise our gains and minimise our losses.

Herding mentality is another emotional dilemma we need to avoid in stock investment. Despite the fact that herding has been practiced by our ancestor for protection since time immemorial, it does not and will not protect us from any loss of capital in investment. In fact, the social pressure of conformity, the delusion of '*professional fund managers cannot be wrong*', and the deadly beliefs that '*they must know something that I don't*' and '*it is safer to do what others are doing than doing it differently*' always result in investors suffer more losses as they bet on something blindly and dump high quality stocks at unreasonable prices when everyone sells. Do you have a feeling of déjà vu about it? According to some research studies, most of the money managers also follow the herd of investment professionals in their stock picking. As a consequence, they underperform major indices more often than not.

Confidence is an important attribute in successful stock investment. Overconfidence, on the other hand, is a dangerous bias that will lead an investor to the path of complete failure. Investors with overconfidence problem usually do not accept opinions contradicting with their personal beliefs. They believe that the values of stocks they possess are higher than the stocks' market prices. The bias of divestiture aversion, also known as endowment effect, will encourage them to take a greater risk when share prices go down. Even worse is that they up the ante by buying more as the prices falter or plunge. Therefore, they are not well prepared for the worst outcome if anything goes wrong. To overcome the overconfidence problem, we must be more open minded, always look out for blind spot, prepare for the worst if the tide turns against our original ideas, and use cut loss strategy to protect our portfolio.

The success of all gurus in stock investment is not credited to their high intelligence quotient or their unparalleled knowledge in investment, but, by and large, attributed to their ability to control their emotions well and to invest with conviction. According to Warren Buffett, investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ. He added further that once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing. Opportunities come infrequently, when it rains gold, put out the bucket not the thimble. During bear attacks, most of the investment gurus become fearless; when everyone is fearful. During bull runs, they stand firmly on the rational ground when everyone is flooded with euphoria. They are willing to go against the crowd to buy more shares of good companies at lower prices when everyone disposes the shares like no tomorrow. That is why they managed to amass enormous fortunes from stock investment.

6.2.11 You Must Own No More than Eight Stocks

Although a reasonably diversified portfolio is good for a novice investor in reducing his or her exposure to the inherent risk of owning just one stock, the portfolio should not be over-diversified. Keeping all our eggs in too many baskets may not be good for us. According to Warren Buffett, diversification is just a protection against ignorance, and it makes very little sense for those who know what they are doing. A balanced portfolio should contain no more than eight stocks.

There are several reasons why we should not own more than eight stocks in your portfolio. The first reason is that the additional stocks we add into the portfolio will not reduce the risk significantly. Moreover, it may reduce the overall gain of our portfolio. Suppose we have a portfolio consists of eight stocks worth Rm 10,000 with an overall gain of 20%, we add another eight stocks worth Rm 10,000 with an average gain of 5% into our original portfolio the following week, and our overall gain will eventually be reduced to 12.5%.

The second reason why we should not own more than eight stocks in our portfolio is that the more stocks that we own in our portfolio, the lesser the amount of time and effort we can allocate to monitor the performance of each stock or each business. If we limit the number of stocks in our portfolio to a maximum of eight carefully selected companies, it does not only save us more time, we can also keep track of their progress easily. All businesses have different challenges and obstacles at different times to overcome. If you can keep track of them, you will know when to buy and when to sell to make more profit.

Chapter Summary

- KYY's golden rule:

  I. Buy companies or stocks with profit growth potential, which have delivered two consecutive quarters of increasing earnings

- Complementary guidelines

  i. Only buy the stocks that you can understand their businesses

  ii. Make sure that the companies have a good track record of making money

  iii. The projected P/E must not exceed 10

  iv. Use leverage to maximise gain

  v. Do not borrow more than the allowable limit

  vi. Sell some that were previously bought using margin loan

  vii. Cut loss will limit your losses

  viii. Do not touch down-trending stocks

  ix. Wait patiently to catch the big fish

  x. Control your emotion of fear, greed, ego and over confidence. Logical thinking is the key to successful investing

  xi. You must own no more than eight stocks