

# Always be a business owner, not a lender

**TO FAST-TRACK** your retirement, you must be a business owner, and not a lender.

I do not mean starting your own business, as the chances of success are slim. What I mean is for you to buy shares from the stock market. A share of stock represents ownership in a business.

If you buy a share of Singapore Telecommunications, it means you own a fraction of Singtel. As a business owner, you are entitled to the dividends and earnings of the business.

Most people do not see it that way. They see the stock market as a casino. They buy at 9am and hope to take profit at 3pm. A stock to them is like a lottery ticket, and not a share of a business. Short-term trading makes your broker rich, not you.

Be a business owner, not a lender. Lending money means putting money into savings accounts, fixed deposits and bonds. The problem with lending money is that you are paid very little interest, which can hardly keep up with inflation. Sometimes, buying poor-quality corporate bonds is not worth the risk.

To reap the benefits of stock investing, you have to understand a bit of mathematics. If you do not really know what equities are all about, you will worry needlessly and may make wrong decisions when the market turns against you. Remember that the stock market is a place where the smart investors take money from the clueless investors.

To illustrate: Ah Seng and Ah Beng each have \$100,000 to invest. Both have a 10-year time frame. Ah Seng is going to invest \$100,000 into a business (see Table A). We will use the term business and stock interchangeably.

Ah Seng's \$100,000 is recorded as "capital" in the table. This business earns a return on equity of 10%. A return of 10% on capital of \$100,000 results in a net income of \$10,000. The business pays out 40% of profits as dividends (payout ratio of 40%). Ah Seng gets \$4,000 as dividends. The remaining \$6,000 is reinvested in the business. This brings the capital at Year 2 to \$106,000. At Year 2, with a 10% ROE on capital of \$106,000, net income is \$10,600 and dividends are \$4,240. After dividends, the remaining \$6,360 is reinvested in the business. This goes until till Year 10.

Little by little, with reinvested earnings and a sustainable ROE, the business has grown quite substantially. The capital base of the company has increased from \$100,000 to \$168,948. Its net income has grown

from \$10,000 to \$16,895. And with it, the dividends have increased from \$4,000 to \$6,758.

Can you see the magic of investing in a business?

Not only does Ah Seng enjoy his dividends, but the reinvested excess earnings in the company are put to work to generate a return of 10%, and the returns from this "excess earnings" are used to pay even more dividends in the subsequent year... and the excess earnings are reinvested again and again. It is like interest on interest, but at a rate of 10%!

One may argue that the figures relating to Ah Seng's company are a myth. There is no such thing as a consistent ROE of 10%, and which business is so generous as to pay out 40% of earnings?

The Straits Times Index ETF, which is represented by 30 big companies listed on the SGX, has an ROE of 9% and a payout ratio of 40%. So, the illustration above is valid as an average listed company on the exchange.

Lastly, let us not forget about Ah Beng (see Table B).

Ah Beng buys a bond for \$100,000, making him a lender. He is paid 5% interest a year, which works out to be \$5,000 a year. So, at the end of 10 years, he receives a total of \$50,000 in interest income and gets back his principal of \$100,000.

In contrast, at the end of 10 years, Ah Seng has collected a total of \$52,723 in dividends and if he sells his business/stock for the value of the capital in the books, he would collect \$168,948. (As a reference, the average valuation for the STI can range from 1X to 1.5X its capital).

The long-term investor with a 10-year time horizon should put his money into stocks. Don't let the short-term price movements scare you and make you lose sight of the fundamental nature of stocks. — [www.aggregate.com.sg](http://www.aggregate.com.sg)

Table A

## Ah Seng's investment in a business

| YEAR         | CAPITAL (\$) | RETURN ON EQUITY (%) | NET INCOME (\$) | PAYOUT RATIO (%) | DIVIDENDS (\$) | REINVESTED EARNINGS (\$) |
|--------------|--------------|----------------------|-----------------|------------------|----------------|--------------------------|
| 1            | 100,000      | 10                   | 10,000          | 40               | 4,000          | 6,000                    |
| 2            | 106,000      | 10                   | 10,600          | 40               | 4,240          | 6,360                    |
| 3            | 112,360      | 10                   | 11,236          | 40               | 4,494          | 6,742                    |
| 4            | 119,102      | 10                   | 11,910          | 40               | 4,764          | 7,146                    |
| 5            | 126,248      | 10                   | 12,625          | 40               | 5,050          | 7,575                    |
| 6            | 133,823      | 10                   | 13,382          | 40               | 5,353          | 8,029                    |
| 7            | 141,852      | 10                   | 14,185          | 40               | 5,674          | 8,511                    |
| 8            | 150,363      | 10                   | 15,036          | 40               | 6,015          | 9,022                    |
| 9            | 159,385      | 10                   | 15,938          | 40               | 6,375          | 9,563                    |
| 10           | 168,948      | 10                   | 16,895          | 40               | 6,758          | 10,137                   |
| <b>TOTAL</b> |              |                      | <b>131,808</b>  |                  | <b>52,723</b>  | <b>79,085</b>            |

Table B

## Ah Beng's investment in bonds

| YEAR         | LOAN AMOUNT (\$) | INTEREST (%) | NET INCOME (\$) |
|--------------|------------------|--------------|-----------------|
| 1            | 100,000          | 5            | 5,000           |
| 2            | 100,000          | 5            | 5,000           |
| 3            | 100,000          | 5            | 5,000           |
| 4            | 100,000          | 5            | 5,000           |
| 5            | 100,000          | 5            | 5,000           |
| 6            | 100,000          | 5            | 5,000           |
| 7            | 100,000          | 5            | 5,000           |
| 8            | 100,000          | 5            | 5,000           |
| 9            | 100,000          | 5            | 5,000           |
| 10           | 100,000          | 5            | 5,000           |
| <b>TOTAL</b> |                  |              | <b>50,000</b>   |