

Five Simple Questions

for Making an Informed Investment Decision

With investment schemes dominating the headlines, investors are more suspicious than ever about whom they can trust with their hard-earned money. When asked about writing an article to help investors identify the good investments from the bad, I was more than happy to oblige. I have seen too many people lose their savings in bad investment deals that are structured to benefit the people selling them, and not the investor funding them.

Hello, my name is Owen Shaw. I am an entrepreneur, investor, and partner in Integrity Wealth Group, Inc.; a Private Fund Management Company. Since starting my investment career, I have made tens of millions of dollars through investments in Real Estate, Oil and Gas and business start-ups. Sometime ago, I was asked how I analyzed different deals to determine which ones were good and which ones didn't look like they had the potential to pay-off. When it came down to it, I realized that my process wasn't nearly as complicated as I had once thought.

Some days, it seems like the financial services world has worked hard to make the average investor so confused that they just hand their money over to someone who appears more knowledgeable than them to have it managed (for a fee). The reality is that good investments are not that complicated. The easier it is to understand what you are investing in, the greater the chance that you will see your money back. In other words, if you don't understand it, don't invest in it. Before I can share with you my five-step process for analyzing any

opportunity, I must first get you looking at investments the same way I do; by keeping it simple.

There are Only Two Types of Investments in the World

There are hundreds of thousands of investments in the world but they all fit into one of only two categories "Debt" or "Equity". In other words, you are either Lending your money to someone in exchange for compensation and the promise they will pay you back in the future or you are Giving your money to someone in exchange for a share in future profits of their business but with no promise of repayment.

Being the Banker

Although you might not realize it, you may already be investing in debt. If you have ever purchased a GIC (Guaranteed Investment Certificate), a Term Deposit, or a government Bond, you have made an investment in debt. These are all debt investments where you lend the bank or the government your money in exchange for what is often a very low rate of return. These groups essentially borrow your money on the cheap and then lend it back to you at higher rates on home loans, car loan, or credit cards. It is a brilliant system and is one of the most profitable in the world.

Being the Venture Capitalist

Equity is when an investor trades their money in exchange for a share in the "equity" of a business. This is most commonly done in the form of stocks (i.e. shares that indicate ownership in a business). When you buy stocks in a business, you do so in the hopes that the business will be profitable.

As a stockholder/shareholder, you will receive a proportionate share in the profits of the business. Investors buy stocks in the hopes that someday they will be able to sell their shares in that business to another buyer for a profit. When dealing in Equity, you must understand that this is not a loan. By buying stock, you have given your money to a corporation that is subject to the risk of market volatility. In a worst-case scenario, if the market value of the company drops significantly, you may not ever see your money again. That company did not borrow your money, so there is no loan to be repaid.

When you look at investing this way, you can see why a majority of successful investors only invest in Debt as it offers some security on the initial investment.

University of Hard Knocks

Over the years, I have made many personal investments and a few of them have taught me some very expensive lessons. When I look back on the deals that cost me money, it was generally because I was investing in the equity of a business that I did not understand. I failed to ask the important questions that I will share with you in this article. I'm sure you have heard the saying "there are no dumb questions, just dumb answers"? Well this couldn't be truer in the investment world.

Identifying a good investment opportunity is like interviewing a prospective employee; you ask a series of questions to see how the candidate answers them. At the end

of the day, the goal of the interview is to identify if the individual is someone who you can trust to get the job done. When researching an investment opportunity the process is the same, only the questions are slightly different.

SITES

SITES is an acronym we use in our business to identify good investment opportunities from bad ones. Each of the letters corresponds to one of five simple questions that you must ask of any investment you are considering.

S - What is the “Security” of my investment?

I - How do “I” make money?

T - How do “They” make money?

E - What is my “Exit” strategy?

S - “Stomach” check, does this feel right?

“S” - What is the “Security” of my investment?

As we discussed earlier there are only two types of investments, investments in Debt or investments in Equity. If you are investing in Debt it is easier to identify the security being offered. As an investor, it is your job to ensure that the security is legitimate. When you purchase a GIC, a term deposit, or a government bond, you are generally guaranteed 100% security on your money because there is insurance in place to protect your investment.

If you are investing in a debt instrument such as a corporate bond or a private loan, you must do your home work to ensure that the party you are lending to has the ability to repay the loan. In addition to ensuring the borrower has sufficient income to repay the loan, you must also identify if a security in the form of a hard asset, such as real estate, vehicles or other personal property will be put up. This will ensure that if the loan is not repaid, you can take

possession of the asset being offered to recover your investment.

When you are investing in the Equity of a business, it is much harder to identify the security as you are not being promised the return of your money. One way to analyze security when investing in a business, is to see how much available cash is on-hand and what hard assets they own, such as real estate, equipment, etc. The challenge with investing in equity is that there is nothing you can do to stop the ownership from spending all of the company’s cash or selling off all of their assets after you purchase your stock. When purchasing equity, stock, or shares in a business, you must have absolute confidence in the management and business’ viability of the company. Look at the track record for the management; have they been involved in similar business that has been successful?

“I” - How do “I” make money?

This is generally where most people stop analyzing an investment. Once they are told they are going to make “X” rate of return on their money, they stop asking questions! What you must understand is that this is where the real questioning begins.

Let’s put on our banker’s hat again for a moment. When you go to get a loan from the bank what are some of the first things the bank wants to know?

Firstly, they want to know how you are going to repay the money they invest (lend) with you. They want to know what sources of income you have and how secure that income is. That is why they ask questions like: where do you work? how long have you been there? how much money do you make? and what are you already spending on other commitments such as housing, transportation, etc? Then they will ask you to provide proof of

everything you have told them. You see, all of these questions are designed to help the bank determine whether you will have the money to pay them the rate of return they are looking for on their investment.

Secondly, the bank will want to know how you are planning on using the money. Is it to purchase a home, a car, a boat? Essentially, they are checking what security they will have, so that if you lose your source of income and cannot repay the loan they can repossess the “Security” and sell it to recover their investment.

Whenever you are told you are going to get something in exchange for your investment, it is vitally important that you understand where the money comes from to pay you that “X” rate of return. If the source of income can’t be easily identified, and if it can’t be proven, then don’t invest.

“T” - How do “They” make money

This is where the sophisticated investor begins to do their homework and it is this simple question that is generally my biggest filter. Essentially there are two ways a company can make money. The first is from their core business. These are the companies you want to invest in. The second is from selling equity in their business to investors. Yes, there are thousands of companies in the world that trade on public markets, and in some cases their primary source of income is from selling stock in their business.

If you are ever looking to invest in the equity of a business, it is crucial that you understand how the business makes money because as an equity investor you are only entitled to your share of that profit. If you do not know and do not understand how the business makes money, then you may simply be giving your money away.

Another way that I identify the risk associated with an investment is to ask the salesperson how much they will make in commission by selling me that investment. The average compensation paid to individuals that are in the business of raising money such as stock brokers, financial planners, advisors and independent agents is between 4% - 8%. However if an agent is being paid more than 8%, you must ask yourself, how risky the investment must be if they need to pay people that much to sell it. There are many groups that pay sales staff as much as 15% to sell their investments. I would suggest you do your homework.

Essentially, I look for a business that profits *with* their investors, not *from* their investors.

“E” – “Exit” strategy

As your needs change, the type of investments you need will also change. Liquidity of an investment is often a big concern for investors as they need to feel comfortable that they can get their money back if they choose to sell an investment. We have already discussed that investing in Equity gives you no promise of getting your money back; however if you can find a purchaser who is willing to buy your shares (public stock markets are built for this purpose), then you can sell your shares and take a profit or a loss depending on the amount someone is willing to offer you.

With Debt investing, there is normally a term on your investment that is tied to the underlying loan in which your investment is held. Although this may impede your liquidity the underlying security of your investment in debt should ensure your capital is safe. Although not all debt investments are tradable (trade to create liquidity; i.e., cash out) many types of debt such as corporate and government

bonds, can be traded on the public markets.

Simply put, the best investment in the world is of little use to me if I have no ability to see my money come back.

“S” – “Stomach” check

Although this may sound like common sense, we all have a tendency to let our minds trick us into doing things we don't feel comfortable with. In my experience, I have found that if after asking the four questions I just shared with you, I still don't feel comfortable, then it is not a deal I should be investing in. Use your good sense of intuition; in the investment world this can be a very important tool in your personal due diligence process.

The Proof is in the Offering

Lastly and maybe most importantly, whenever you are looking at an investment opportunity you should receive a copy of the legal offering documents, this would be a Prospectus or an Offering Memorandum. If you are not provided with a Prospectus or Offering Memorandum document, then you must be very cautious if you choose to proceed any further.

The Prospectus or Offering Memorandum is a legal disclosure document where the company raising capital (the “Issuer”) must put every detail of the deal in writing. This is not just an executive summary but a full legal document where the principals of the issuing company sign a statement declaring that the contents of the document are 100% accurate. If false statements have been made in the offering then the principals who sign the document could face heavy fines or jail time.

These are not fun documents to read and some of them can be very lengthy, but I encourage you to read the document in its entirety. I have

found a bit of a short cut that can save you time. Remember that person who is selling you the investment? It may be your stock broker, your financial planner or an independent representative of the Issuer, but whoever they are, they are going to receive a commission for selling you the investment so it is not unreasonable for you to insist that they put the time in to walk you through the document.

It is perfectly okay for someone to earn a commission when they are helping you cut through all the bad deals out there and get to the good ones. Don't forget, the commission they are making is essentially a commission that you are paying them so don't feel bad about asking them to do some of the work for, or with you. When I am looking at a deal I ask the sales person to show me and highlight everything in the offering document that backs up the statements they have made to me when they answered the questions I listed above. If they can't, then I thank them for their time and I don't invest.

I hope these tools will help you in your personal investing careers. Remember, if you don't understand it, don't invest in it! If you understand it, it makes sense and you are happy with the answers of your SITES analysis, then invest, and sleep well at night! ●