BUY-OLOGY

Value investing with Roger Montgomery

What are your shares really worth?

In the last two issues of *Open Road* I have outlined the steps to navigating the stock market's inexplicable rises and falls. Simply buy great businesses at prices below their intrinsic value and hang on to them for as long as they remain both great and cheap. The question I receive most is, how do I calculate the true value of the best stocks?

The price of a share is not its value. Price is what you pay and value is what you receive. Your job is to buy when shares are below value and to do that you must know the true value.

Imagine a $1 million dollar bank account that pays out 20 per cent annually and I put it to auction. You can be certain someone will pay more than $1 million for it. Many will correctly appraise the risk is low and be happy with, for example, a 10 per cent return. In simple terms, an investor happy with half the returns produced can pay twice the balance of the bank account, or $2 million. This is the intrinsic value of the account. If you can buy it for less, you will do well.

It's the same with shares. The bank balance is the equity on the balance sheet (Equity) and the return is known as return on equity (ROE). The return you seek is called the required return (RR) and the basic formula is:

INTRINSIC VALUE = ROE / RR x EQUITY

Next issue, we'll apply the model to a few real stocks.

Roger Montgomery is a noted investment analyst. His new book Value.Able *shows how to value the best stocks and buy them for less. Hardcover first editions are available at* **www.rogermontgomery.com**.

* NRMA does not necessarily support the independent advice in this column.