SPECIAL AWARDS EDITION BEST-VALUE PRODUCTS

Money

JUNE 2010 $6.95 ISSUE 124
www.money.ninemsn.com.au

FREE TICKETS TO HOME BUYER & INVESTING EXPOS

REAL ESTATE BOOM

WHERE YOU CAN STILL FIND BARGAINS

TOP PRODUCTS TO SAVE YOU MONEY

Money

JUNE 2010 $6.95 ISSUE 124
www.money.ninemsn.com.au

CONSUMER FINANCE AWARDS 2010 Money MAGAZINE AWARDS 2010

BANK OF THE YEAR

WHERE DOES YOURS RANK?

HOME LENDER OF THE YEAR, INSURER OF THE YEAR, CREDIT CARD ISSUER OF THE YEAR + MORE

+

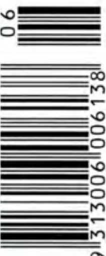
TOP 11 VALUE SHARES
Portfolio returns 41%

EARN AN EXTRA $200 A WEEK
All you need is a car

SLASH YOUR TAX
What to do before June 30

SPECIAL INVESTIGATION
Beware payday loans

BUILDING WEALTH VIA DEBT RECYCLING PAUL'S VERDICT



PRINT POST APPROVED PP255003/04450

acp magazines

How to buy shares

Roger Montgomery introduces his new column on constructing a winning share portfolio

"Sticking to great businesses results in superior returns"

WHILE EVERYONE APPEARS to be obsessed with the prices of everything, especially houses and shares, I only look at the prices of my shares occasionally. How silly of me not to look more frequently as I would have discovered much earlier just how well the 11 companies I suggested in my report here in *Money* nearly a year ago, *How to Buy Shares*, were travelling.

In this issue of *Money* we review last year's picks and launch a new column that might just be the last word on investing in the stockmarket. Advocating a slow and steady path to a certain fortune rather than hoping for quick riches, last year I suggested repeating a few sensible things in the stockmarket over long periods of time. I promised that following the steps I outlined and the companies those steps produced would "almost certainly improve your bank balance".

That appears to have been the case, thanks in part to the return of optimism and risk taking. According to the fortune tellers, the difficulties of the global financial crisis are behind us; we're now told they were never really in front of us and as a result we were all very silly to sell shares down to such ludicrously low prices.

But when those around you see nothing but despair and trouble ahead, that is when the best opportunities arise. It was just that kind of environment that was influencing investor thinking 12 months ago.

If you ignored prices and simply constructed an equally weighted portfolio of the 11 companies I mentioned – Cochlear, CSL, the major banks, Realestate.com (REA Group), Woolworths, Reece, The Reject Shop and Fleetwood – your portfolio's pre-tax value would have risen by $41,080 in the past 10½ months for every $100,000 you had invested, or not far off half a million for every million invested.

That's not a bad return for less than a year, when compared with the results available in bank accounts or offered by the broader market. The return is almost entirely attributable to the quality of the companies that were being thrown out with the bath water all those months ago.

In the sharemarket even the most experienced financial, property or medical professional falls into the same traps frequented by the new investor – tending to buy too early, pay too much, hold on too long and cross their fingers in the hope share prices will miraculously rise. More disconcertingly, many of them freeze when prices drop – precisely the time they should be jubilant.

Having outperformed the market for some time, I can assure you that sticking to great businesses results in superior returns. Each of the companies in last year's list I regard as very high quality and the very best I call my A1 companies.

Of the 1888 listed shares on the Australian Securities Exchange, there are less than 100 that I regard as A1 or A2 in a ranking system I use that goes all the way down to C. You cannot help but do well buying high-quality companies, as long as you are not in too much of a rush. You will do even better if you can be patient enough to buy the shares of those companies when their prices are below their "true" value.

So it's time to knuckle down, because over the next year I am going to lift the veil on value investing and constructing attractive share portfolios. I am going to show you how to identify a great business and estimate its intrinsic value.

Examining each sector of the Austral-

ian market, I will highlight those stocks with the strongest and weakest investment merit, and if the correct conditions present themselves, discuss individual opportunities. I will surround the discussion with the scaffolding to build a portfolio of great businesses whose intrinsic values should rise over the next few years and beyond.

The first thing is to change the way you think about the stockmarket. If you bet on shares that rise and fall, the way you might bet on black or red at the casino, you aren't investing at all. You are speculating. You are likely to be excited when prices rise and despondent or panicked when they don't.

Investors see things differently. An investor regards a share as a claim over the income and net assets of the company. An investor sees shares for what they really are, not casino chips but ownership stakes in businesses.

When prices fall, an investor gets excited because low prices mean more of a good thing can be purchased at even more attractive prices.

Once you have reframed your understanding of shares, the next step is to identify great businesses and avoid the mediocre ones. This is easier than you think. Suppose you and I start a business with $2 billion of our own money and $3 billion from the bank. We run the business for a decade, after which our annual profits are about $100 million. Doesn't sound like a great result does it?

Adding salt to the wound, what if I told you that over the past decade we have injected a further $2 billion of our own money and borrowed another $3 billion.

If you can see that this is not the sort of business you would like to own, you are well on your way to becoming a true investor and making some decent returns. You see, the above example is not a hypothetical example, it is actually an iconic Australian company and its share price has done little in 10 years.

Investors know that over the long term shares prices tend to follow the performance of the business.

If you focus on the business, buying the good ones and avoiding the mediocre and disastrous, the share prices tend to look after themselves.

The final step is valuing a business and only "great" businesses should be considered for purchase. Great businesses – my A1s – are those able to sustain high rates of return on incremental equity for many years, while employing little or no debt.

They also have capable management who understand how to allocate capital and, more importantly, the best can survive a period where poor management might be in control. When the price is below the value, take advantage of that rare opportunity and ignore the mood of the market at the time.

So how do you determine the value of a business? In 1981, none other than Warren Buffett outlined the steps and for companies that pay all their earnings out as a dividend it is relatively simple.

The formula is: return on equity divided by your required post-tax return times the equity per share. Using this model, a business that can generate a high rate of return on equity is worth more than a business that cannot. This is rational.

A year or so ago I applied the formula to Telstra. It had about 93¢ of equity per share that generated a return of 35% to 40%, of which it pays most, if not all as a dividend. Assuming an 11% required post-tax return, Telstra was worth 0.35 ÷ 0.11 X 0.93 = $2.95. The shares were trading at about $3.20 then and I concluded they were "no bargain".

As you know, the stockmarket has rallied strongly over the past year and yet Telstra's shares are lower today than they were a year ago. It seems the valuation method could just be worth paying attention. In coming issues of *Money*, my new column will allow you to do exactly that.

TOP 11 VALUE SHARES

COMPANY	CODE	PRICE 1-JUL-09	DIVND	GROSSED UP	PRICE 13-MAY-10	TOTAL RETURN
ANZ Bank	ANZ	$16.49	$0.56	$0.80	$23.29	46.09%
Commonwealth Bank	CBA	$39.00	$2.35	$3.36	$54.94	49.49%
Cochlear	COH	$57.70	$1.90	$2.71	$76.53	37.33%
CSL	CSL	$32.15	$0.75	$1.07	$33.51	7.56%
Fleetwood Corp	FWD	$5.90	$0.66	$0.94	$9.14	70.85%
NAB	NAB	$22.44	$0.73	$1.04	$25.95	20.28%
REA Group	REA	$5.95	$0.10	$0.14	$11.45	94.79%
Reece Australia	REH	$18.00	$0.53	$0.76	$24.60	40.89%
The Reject Shop	TRS	$11.72	$0.62	$0.89	$16.15	45.39%
Westpac	WBC	$20.25	$0.60	$0.86	$25.28	29.09%
Woolworths	WOW	$26.36	$1.09	$1.56	$27.48	10.17%
					Portfolio Performance (pre-tax)	**41.08%**
					All Ordinaries Accumulation Index Perfomance (pre-tax)	**24.91%**

Portfolio weighted so that equal value parcels were bought for each stock; grossed-up dividends included in returns.

ROGER MONTGOMERY

Roger Montgomery is a value investor and fund manager. His guide to picking the best stocks, Value.able, is available at www.rogermontgomery.com