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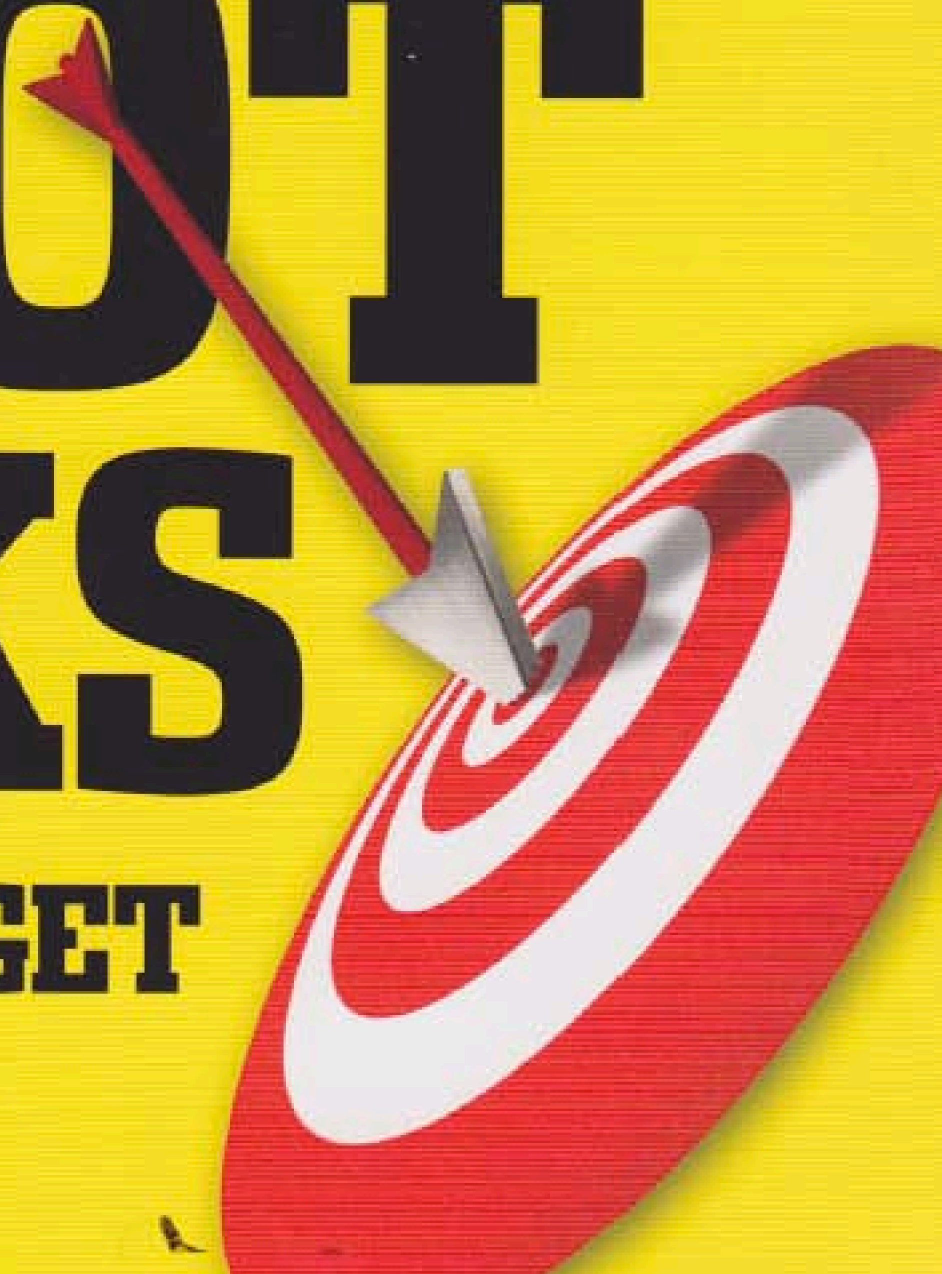
15 HOT STOCKS



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Great retail stocks

Roger Montgomery shows how to do your homework and pick superior stocks

I HAVE ONE GOAL: TO HELP YOU MAKE your future more comfortable. But I can only do that if you change the way you approach the stockmarket. I want you to start by turning it off. Don't let yourself be distracted by its constant noise.

Many years ago, the intellectual "dean" of Wall Street, Benjamin Graham, suggested that in the short run prices for shares were determined by the votes of people who had money but were neither intelligent nor emotionally stable. The only useful conclusion is that you are wasting your time predicting short-term share prices.

Thankfully, Graham also said that in the long run, the market is a weighing machine. So, in the long run, prices tend to follow the underlying performance of a business.

In this month's column, I want to show you how to tell the difference between an exceptional business and an ordinary one.

The first business is global packaging giant, Amcor. Ten years ago it earned $290 million. In 2009, it earned $211 million. Falling profits are generally not the point of going into business. Ten years ago, to generate that $290 million profit, shareholders had invested $1.8 billion and the banks had lent $1.4 billion. In the intervening decade, shareholders had either injected or allowed the company to retain an additional $1.6 billion and the banks had also lent an additional $1.4 billion.

The additional equity from the owners and the banks has not produced a positive return. Profits have gone down. Had you borrowed $1.4 billion and put this in a bank, along with $1.6 billion of your own money, you would have generated a higher return.

Would you be happy if you were the sole owner of this business? Warren Buffett said that if you are not prepared to own the whole business, you should not buy a piece of it.

The next example is medical centre and

pathology company, Primary Health Care. This company has increased profits by $103 million in 10 years, from $5 million to $108 million in 2009. That increase needs to be compared with the amount of money the owners have put into the business. Ten years ago owners had invested $110 million. Since then however, they have tipped in or kept in an additional $2 billion.

Comparing the increase in profits to the increase in equity contributed by the owners produces a return of just 5% and it doesn't take into account the $1.4 billion of loans the banks have given the company. I wonder whether, given these statistics, you would be happy owning Amcor or Primary outright? Neither company currently demonstrates an economic track record sufficiently desirable to warrant total ownership.

Like Primary and Amcor, grocery retailer Woolworths has also increased equity and debt substantially over the years. Owners have injected equity and retained profits within the company of $6 billion. But profits have increased by $1.5 billion in the same time. The increased equity contributed by the owners has, in effect, produced a return of 25%. That's the sort of return you cannot obtain in a bank account.

The second part of the investing puzzle is the intrinsic value of a company – you must only buy businesses at discounts to their intrinsic value. Importantly, if preserving your financial future is high on your list of priorities, then you must only buy exceptional businesses at discounts to intrinsic value. I thought it might be worth taking a look at a few retail businesses to determine which are demonstrating the sort of economics that is desirable, and which are not.

You can make your future comfortable by spending money on things you like and want or you can invest it in great businesses.

This month's table applies the above methodology for identifying superior businesses to listed retail companies as a primer for you to do your own research in a structured and consistent way. Think of it as a different type of "retail therapy". The first step I will leave for you to do is to examine how much debt these companies have overall and how much that debt has changed in the past decade. Has it declined or increased? Now you are starting to think in a businesslike fashion.

RETURNS ON RETAIL STOCKS

COMPANY		2000 ($M)	2009 ($M)
Oroton (ORL) ROAE 138.41%	Profit	$4.80	$19.43
	Equity	$16.42	$26.99
The Reject Shop (TRS) ROAE 54.49%	Profit	$2.55	$18.99
	Equity	$9.29	$39.46
JB Hi-Fi (JBH) ROAE 44.42%	Profit	$1.80	$94.44
	Equity	$20.70	$229.25
David Jones (DJS) ROAE 43.52%	Profit	$35.80	$156.52
	Equity	$409.70	$687.10
Cash Converters (CCV) ROAE 32.78%	Profit	-$3.93	$16.16
	Equity	$21.80	$83.09
Thorn Group (TGA) ROAE 26.62%	Profit	-$2.86	$19.50
	Equity	-$2.50	$81.50
Billabong (BBG) ROAE 15.64%	Profit	$42.06	$152.84
	Equity	$515.30	$1223.40
Allied Brands[1] (ABQ) ROAE 12.32%	Profit	-$0.30	$2.95
	Equity	$4.41	$30.80
Wesfarmers (WES) ROAE 5.75%	Profit	$207.03	$1535.00
	Equity	$1225.20	$24,338.00
Noni B (NBL) ROAE -17.54%	Profit	$2.89	$1.49
	Equity	$15.55	$23.53

[1] 2004-09 comparison.
Ranked by ROAE (return on added equity) from best to worst

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Roger Montgomery is a value investor and fund manager. His book, *Value.able*, is available at www.rogermontgomery.com