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The art of collecting

Roger Montgomery explains the difference between investing and speculating

A PORTFOLIO OF THE BEST businesses, purchased at discounts to their true values and built stock by stock, has proved to be the missing link of investing – higher returns with lower risk. And speaking of lower risk my table lists some businesses on the stock exchange with the lowest chance of ever going under. They also demonstrate the best operating performance over time and have the best expected returns. I call them my "A1 businesses" and as in any good collection they are incredibly rare.

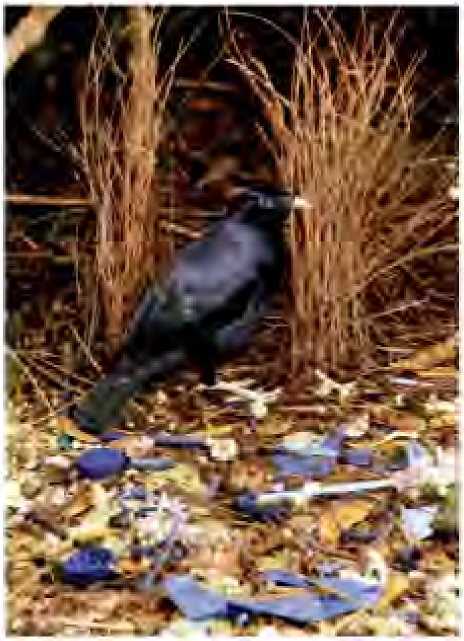
I regard them as of the highest quality and therefore with the lowest risk and most likely to outperform over a long time. That of course is subject to events and influences outside of the company's control. For example, Monadelphous, WorleyParsons and Fleetwood Corporation cannot control how much of Australia's commodities China continues to buy. Their profits, however, are indirectly related to that influence.

I can lower the risk even further by only purchasing their shares at a discount to their intrinsic values. Today, only the shares of Oroton and JB Hi-Fi, my pick of the month, are trading at prices that represent discounts to intrinsic value and they are not absolute bargains.

If I really wanted to minimise my risk, buying any of them right now might not work. If you have a 10-year time horizon or longer you could expect to do better than the average, keeping an eye on each and ensuring they remain A1 companies and that their intrinsic values continue to rise. But you can do better if you're patient.

Patience is a necessary virtue for becoming a successful share investor rather than a speculator. Investing and speculating are two different things. Speculating is a lot like gambling, investing is more akin to collecting.

The best investors don't collect any old



junk, although many first-time investors have become expert at that. The most valuable collectors' items are those that are rare and the best collections are built by those who look far into the future for what those items might be truly worth.

Building a portfolio that over time will do better than the market requires the same temperament as collecting. Patience, diligence, determination and focus are all characteristics of the world's best investors. The other characteristic that is needed is the ability to negotiate a bargain.

The collections with the best returns are those whose items have risen most, bought at ridiculously cheap prices, or both. The stockmarket will offer you an opportunity to buy every day. If you don't like today's price you can ignore it and the market is not offended. In that sense you can negotiate the best price. All you need is patience.

Most people take their investment cues when investing from prices. They believe that if the price is rising this means the company is "good" and risk is declining. Conversely, when the price is falling, the company must have done something wrong and the risk is becoming greater.

To my way of thinking the reverse is true. As prices rise, the stock becomes more expensive, more risky and less attractive. As prices fall – provided of course the value of the company has not changed – the stock becomes more attractive and less risky because the lower the price you pay the higher your return.

THE A1 BUSINESS LIST

COMPANY	ASX CODE	RATING[1]	FORECAST 3YR GROWTH[2]
ARB Corp	ARP	A1	28.20%pa
carsales.com	CRZ	A1	26.93%pa
WorleyParsons	WOR	A1	24.09%pa
CSL	CSL	A1	18.99%pa
JB Hi-Fi	JBH	A1	15.53%pa
REA Group	REA	A1	12.97%pa
OrotonGroup	ORL	A1	11.29%pa
Cochlear	COH	A1	10.83%pa
Monadelphous Gp	MND	A1	10.47%pa
Fleetwood Corp	FWD	A1	9.18%pa

[1]Montgomery's quality score. [2]Forecast average annual change in intrinsic value over 3 years.

VALUE PICK OF THE MONTH
JB Hi-Fi

SOURCE: BLOOMBERG

So the first step is to ignore prices – take your cues from the businesses underlying those shares. Great businesses over time will outperform poorer rivals. And provided you are not in too much of a rush, the share prices of good businesses will outperform the share prices of weak businesses.

Put together a portfolio of extraordinary businesses and with a long enough time line, you cannot help but avoid ordinary returns. Now imagine how much better you will do if you buy these extraordinary businesses at bargain prices. And that's how to go about building a wonderful share collection.

Next month we'll look more closely at some of these companies and compare them with their less salubrious peers.

ROGER MONTGOMERY

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