SHARE BUYS: 13 STOCKS THAT TICK THE BOX

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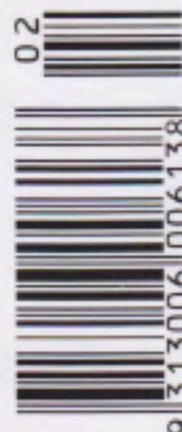
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3 steps to success

Roger Montgomery reckons 2011 can be a real cracker

BEREFT OF THE FOLLY OF impossible-to-keep new year's resolutions, here at Montgomery Investment Management we'll stick to the steps that worked last year and revealed companies such as Decmil, Forge Group and Matrix Composites & Engineering. To put some perspective on the possible benefits from the value investing approach practised here, Mining & Civil Australia has risen more than 70% and the other contractors have doubled or more.

It is my only investing hope this year that there will be enough similarly attractive opportunities presented to employ my capital – and now that of the Montgomery [Private] Fund. That's the way to beat the market and I do not feel the current climate is particularly adverse, but of course nothing is ever guaranteed!

Let's start the year with a refresher class; call it value investing 101. Before we begin, let me say that a major reason the sharemarket is such a challenge for many investors is they approach it all wrong.

There is a far simpler and more successful way to invest in the stockmarket. First accept that you won't beat it every year – patience is a must. Once you discover how to identify great businesses and the right price to pay, the only challenge left is to avoid being distracted by the market's noisy temptations. Taking cues from prices and watching the "market" is the most common mistake. Many believe if prices rise the stock must be "good" or someone smart must know something. If prices fall, the company is "bad" and someone definitely knows something. In reality the reverse may be true, but without turning the stockmarket off, it's hard not to be swayed by its destructive temptations.

Approach stocks the same way you would if buying an unlisted business. So, when assessing a listed company's shares,

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you will look for the right things – high rates of return on equity, little or no debt and an identifiable competitive advantage.

Step number 1 then is: Turn the stockmarket off. Step number 2 is: Identify great businesses and avoid the bad ones.

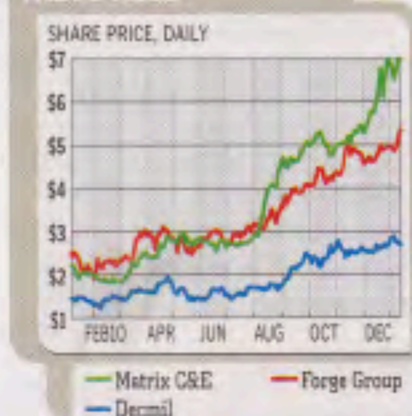
Suppose we invest $110 million of our own money into a business and borrow $31 million and then earn $5 million in our first year. Now suppose we run the business for another decade and in the 10th year earn a profit of $108 million.

Many investors would celebrate but it's not only the profits that come out of a business that are important. You must consider how many of those dollars are required to be reinvested to generate those profits. What if I told you that in the past 10 years you have had to inject a further $2 billion of your own money, and borrow an additional $1.4 billion?

Suddenly there is nothing remarkable about profits growing from $5 million to $108 million. You could achieve that – a return of just 5% – by putting a couple of billion extra into your bank account.

And this is not some hypothetical example. The numbers belong to a company called Primary Healthcare. Great businesses are those that can sustainably generate extraordinary returns – not 5%. Finding great businesses is as easy as avoiding the inferior ones and that's step number 2.

Knowing the intrinsic value of a great company is step number 3 and the last part of the story. Intrinsic value represents



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the rock in a violent sea of ever-changing prices, opinions and speculative activity. As Ben Graham, the intellectual dean of Wall Street, once instructed, it's the market's wallet you want, not its wisdom.

It is imperative then that you avoid listening to the market; turn it off and estimate the intrinsic value of a company's shares BEFORE you invest in them.

Finding intrinsic value can be completed by following a few simple steps and you really only need a handful of numbers. In my book, *Value.able*, each of the simple steps to obtaining an estimate of the intrinsic value of a business and its company's shares is explained so that you can see when a bargain is being presented.

To put it as simply as possible: if a CEO who plans on hanging around can compound a dollar of equity at 15%, with no help from debt, that equity is worth more than a dollar. If it is available for less than a dollar, you likely have a bargain.

Just three simple steps, if followed sensibly, should produce satisfactory results over time. By learning to turn the stockmarket off, separate the extraordinary businesses from the ordinary, and understand what they might truly be worth, you will have all the tools you need to beat the market over the long term. Next month we'll look at major investment themes that will influence your returns this year and where you should be searching for value. To whet your appetite, think China's relaxation of foreign investing rules for its citizens, climate change and US interest rates.

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Roger Montgomery is a portfolio manager at Montgomery Investment Management. His book, *Value.able*, is available at www.rogermontgomery.com