EQUITY

standing up for shareholders

February 2011 Vol 25 #2

IS YOUR STOCKMARKET ON OR OFF

ASIC: FOREX TRADING
At your own risk

STOCKWATCH:
Elio D'Amato profiles DCG

FREE INVESTOR PASSES
See Page 23 for the Resources Conferences dates and your FREE invitation & lunch for ASA members

+ WHAT IS IN STORE FOR 2011?

Australian Shareholders' Association

STANDING UP FOR SHAREHOLDERS

IS YOUR STOCKMARKET ON OR OFF?

by Roger Montgomery

The New Year is typically a time for resolutions and when it comes to the task of increasing one's wealth, good intentions are often met with sore disappointment.

Bereft of the folly of impossible New Year resolutions, at Montgomery Investment Management it's the same ol' same ol'. We continue to search the universe of stocks for extraordinary businesses trading at deep discounts to our estimate of their intrinsic value.

In 2010 I publicly discussed Decmil, Forge and Matrix Composite & Engineering, as well as the float of MACA and the retailer Oroton as complying candidates. The subsequent returns of these stocks have trounced that of the S&P/ASX 200 Index. MACA has risen more than 70 per cent and the others have all doubled.

My only want this year (it's the same every year), is that there will be a sufficient number of similarly attractive opportunities presented to employ my capital and 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 with regard to the attainment of this goal. But of course nothing is ever guaranteed!

To bring you up to speed, allow me to take you on a brief journey I am qualified to lead and while some may disagree with the itinerary, I have traveled the route many times and found it to be an immensely rewarding tour.

To end the tendency of your portfolio to simply lurch from one crisis to the next, change the way you approach the market.

The market is more volatile than desired and much more unpredictable than many professional investors may have us believe. A 'blue chip' stock is not a low risk investment and a high yield stock is not 'defensive', yet we are served this conventional wisdom and pay for it not only in fees, but in the opportunity lost to earn superior returns.

Many investors perceive the stock market as a challenge because they approach it the wrong way. I advocate a far simpler and more successful way to invest.

Beating the market is not as hard as you may think, however you do need to accept that you won't beat it every year and patience is a must. Once you discover how to identify great businesses and estimate the right price to pay, the only challenge is to avoid being distracted by the market's noisy temptations.

Taking cues from share prices is the first and most common mistake. Many believe if prices rise, the stock must be 'good' or that someone smart must know something. Sound familiar? Conversely, if prices fall the stock is 'bad' and someone definitely knows something. In reality the reverse may be true, but without turning the stock market off, it's hard not to be swayed by its temptations.

If you approach buying stocks the same way you would approach buying an unlisted business, everything would change. If buying the local butcher or fast food franchise, what would you look at to assess its financial position? Your checklist would inevitably be the same as your checklist for assessing the securities of a listed company.

I know of some businesses that generate returns of more than 50 per cent on their investors' funds. Compared to the six or so per cent available from a term deposit, such a business would be a very attractive proposition. No wonder renowned investor Warren Buffett doesn't mind if the stock market closed for a few years.

The very exciting thing about the stock market is that once you are able to turn away from its distracting temptations, you can take advantage of its bipolar nature. If the price of a great business has been pushed below its intrinsic value because of some temporary event that is being treated as though it is permanent, you can see the opportunity for what it is.

STEP 1

Turn the stock market off

STEP 2

Identify extraordinary businesses

Let's suppose I offer you the opportunity to invest in a business with me. We will invest $110 million of our own money and borrow $31 million from the bank. In our first year we earn $5 million. Now suppose we run the business for another ten years and today, we earn a profit of $108 million. Sounds pretty good.

But it's not only the profits that come out of a business that are important. How many of those dollars that are required to be reinvested to keep the business running must also be considered?

If any additional equity has been injected over the ten years or further debt drawn down from the bank, then we should know about it. What if I told you that in the last ten years you had to inject a further $2 billion of your own money and borrow an additional $1.4 billion to grow the business? No wonder the profits have grown from $5 million to $108 million! You could do the same thing by putting a couple of billion extra into your bank account. It is nothing remarkable. The company now has the benefit of over $2 billion of your capital and is earning $108 million - a return of just five per cent.

This is not a hypothetical example. The numbers belong to a company called Primary Health Care Limited (PRY). Would you be happy owning a business for a long time that earned just five per cent? The longer you stay invested in this business – if it continues to generate five per cent - the more you are giving away in opportunity costs and higher returns elsewhere.

Great businesses are those that can sustainably generate extraordinary returns. Finding them is as easy as avoiding the bad businesses.

Have a look at Oroton's numbers since Sally MacDonald joined the company in 2006. The year before Sally was appointed CEO, Oroton earned just $1.6 million in profit. Today its earns $22 million. Now, this company has also had the benefit of additional capital. Equity contributed by owners since 2005 amounts to $10 million, but each one of those dollars has produced a return of almost two. Ten million additional dollars have been invested by shareholders but that money has increased profits over the same period by about $20 million. This two to one ratio is impossible to achieve in a bank account. At the same time debt has fallen substantially. These are the sorts of numbers that, if they continue, encourage me to want to own the whole business and its people. I would be quite content to see the stock market turned off for several years, if I owned a business like Oroton.

Knowing the intrinsic value of a great company is Step Three and the last part of our journey. Intrinsic value represents the rock in a tempestuous sea. The changing tides of opinions and speculation can wash around you, but the valuation doesn't move. You are free to take advantage of the market's indecision or ignore it. Just don't be influenced by it. As Ben Graham, the intellectual dean of Wall Street once instructed, it's the market's wallet you want, not its wisdom.

Without repeating them here, finding intrinsic value can be completed by following a few simple steps and you really only need a handful of numbers. In Value.able (order at www.RogerMontgomery.com), I explain each of my simple steps to obtaining an estimate of the intrinsic value of a business and its company's shares 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 per cent, 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 in front of you.

Just three simple steps, if followed sensibly, should produce satisfactory results over time.

So turn the stock market off, think about shares as pieces of businesses in which to invest rather than as gambling chips on which to bet on 'up' or 'down', and know how to value a company. Do these things and over time, you should do reasonably well.

By learning to turn the stock market off, separate the extraordinary businesses from the ordinary and understanding what they might truly be worth, you will have all the tools you need to beat the stock market over the long term.

Roger Montgomery recently established Montgomery Investment Management www.montinvest.com and is the author of Value.able, available exclusively online at www.RogerMontgomery.com