In this edited extract from his book *Value.able*, Roger Montgomery explains how to select the best shares and buy them at prices below their true worth.

Value in your hand

IRRESPECTIVE OF YOUR AGE and whether you are investing part time, full time or for the first time, *Value.able* will help change some aspect of the way you have been investing. It may even change everything. Its value will be directly proportional to just how much it transforms what you have been doing up to this point. Whether you are a newcomer to share investing or an old hand and reckon you know a great deal, the steps, rules, ideas and strategies I share could dramatically improve your long-term returns.

Successful investing requires commonsense. I am often staggered to discover that when it comes to investing on the stockmarket, commonsense isn't all that common.

This book offers three steps to safely buying the best shares: steps that should give you the highest long-term returns. It is structured in three parts – one for each step. By following the steps, things should work out well.

Most importantly, you are going to discover that you already know how to do well in the stockmarket. If you have been able to spot a bargain in another currency while travelling overseas, or at the local supermarket (for example, you worked out that buying loose oranges at $5.95 a kilo is cheaper than buying a two-kilo bag for $13.50), then you might actually be overqualified for the journey you are about to embark upon.

Overqualified or not, it's a journey you will find incredibly valuable.

Value.able will give you the tools of value investing – a disarmingly rational and simple approach, based as it is on the proposition that your job is to buy, below value, shares of a superior business. I like to call them my "extraordinaries", and you are more than qualified to tell the difference between an extraordinary business and an ordinary one with publicly available information.

This book is written to show you that you can beat the experts and that you already know a bargain when you see one. You already have the skills to tell the difference between an extraordinary business and an ordinary one.

These are the three steps, each of which is covered in detail in the three parts of the book.

Step 1: Think like an investor

It is a mistake to operate under the assumption that the "market" (the majority) knows more than you. Your job is simply to buy an extraordinary business at a bargain price. Preferably it will be a business that will earn lots more money in the future and is run by management and a board that treat you

GETTY IMAGES

IN A NUTSHELL

The worth of Woolworths

Woolworths meets the *Value.able* criteria for extraordinary businesses – high return on equity (average 35% since 2001), sustained competitive advantages, low debt (average 35% 2008), positive cash flow and bright prospects.

The next step is to calculate its intrinsic value.

First, source your ingredients: equity per share, payout ratio (the proportion of earnings the company is expected to distribute as dividends) and return on equity. Finally, select a rate of return you believe is reasonable to aim for, taking into account the risk – something like 10% or 11%, perhaps.

Next, if you have the book, refer to the two tables on pages 183 and 184. Woolworths pays some profit as dividends (the income intrinsic value), and reinvests the rest in the business (growth intrinsic value). Use the first table to produce the income intrinsic value and the second, the growth intrinsic value. Now, adjust by the payout ratio, add the two together and there you have it! Your estimate of Woolworth's *Value.able* intrinsic value.

My intrinsic value estimate for Woolworths is currently between $25.61 and $26.08, forecast to rise to $28.40 in 2012 and $31.34 in 2013.

Finally, turn the stockmarket back on. Is your estimate of intrinsic value significantly higher than the market price?

See Value.able, page 87.

like an owner, rather than lavish gold upon themselves.

So turn off the television, the market reports on the radio and all of the daily updates and commentary about why stocks went up or down today. The so-called Holy Grail has nothing to do with knowing which stocks will go up or down.

Focus on businesses rather than stocks. Concern yourself with understanding businesses. Then you can identify the truly extraordinary ones, avoid the most risky, and generally navigate the gamut of market conditions with confidence.

Thinking like an investor means understanding the difference between price and value, and the difference between a business and a stock. If you have not done as well in the stockmarket as you believe you should have, it is highly likely that you have been led astray by an industry preoccupied with the price of everything and the value of nothing. You may have been looking at stocks as casino chips and betting on whether their prices will rise and fall, rather than considering them as pieces of businesses.

Price and value are two entirely different things. The focus on price – which prevails in stockmarkets the world over, dominates the business media and constantly vies for your attention – leads to attempts to try to predict its course. Some people are so focused on price that what the business does, what it sells, who is running it and what its economics are like is largely irrelevant.

They buy shares simply because they believe they will go up. Once you start doing that, you are not an investor any more, you are a gambler.

Buying and selling shares based on a prediction of the future course of their price is speculation, not investing.

Focusing on value, while ignoring price, helps develop an investing mindset. True value does not change, irrespective of what people may hope or expect it to be.

The only thing that changes the value of a business is its economic performance.

Step 2: Identifying extraordinary businesses

To be financially successful in the stockmarket, you really only need to understand a few concepts. They boil down to this: buy extraordinary businesses at bargain prices and continue to hold them until they cease to be cheap or extraordinary.

Your job as an investor, I believe, is to pay a price lower than the value you receive. It is also to put together a manageable portfolio of outstanding businesses, whose profits generally rise over time and whose economics are, and remain, superior.

If, for any reason, the businesses cease to demonstrate the ingredients for which they were selected, then the investment is sold and replaced with another that meets all the other criteria. For example, get rid of businesses when their economics deteriorate or their shares are priced far in excess of your valuation, either because the price has advanced too far or the value has declined.

If you cannot find a replacement, you may consider investing the proceeds in the safety of cash until another opportunity for safe and superior returns can be found.

Step 3: How to value a business

In part three you will understand how to value businesses so that you will be able to recognise the ABC Learning and Coles takeovers of the future. If you discover the approach to investing outlined in *Value.able* does make sense to you, it is imperative that you apply it with consistency.

Estimating the value of a business and its shares is not the same as predicting their short-term direction. Market timing – trying to make profits from getting the rises and falls of a single stock or the market right – is the antithesis of the approach outlined here, which to some may seem lazy or even slothful.

Often the research of the patient, long-term business-focused investor will lead to the "do nothing" conclusion – anathema to an industry whose entire reason for being and whose source of revenue is activity.

William F. Sharpe, a mathematician and Nobel laureate, found that market timers needed to be right 82% of the time to match the returns of the buy-and-hold approach, which also has less risk and lower transaction costs.

This book is by no means the last word on investing, but it will go a long way to dispelling some of the conventions in the market that I firmly believe mislead you, by putting you on the path to speculation, uncertainty and nervousness.

The strategy outlined here seeks a very high return with relatively low risk. And the

highest returns occur when all of the criteria are met. An extraordinary business, excellent management and bright prospects must be accompanied by a discount to a rational estimate of the company's true value, or what is commonly known as intrinsic value.

Yet despite its obvious relevance, its time-honoured success and the public support for it by some of the world's wealthiest and most successful individuals, most investors – private, professional and corporate – have ignored this plan for decades because, while it offers almost certain success, it doesn't promise quick profits.

The right mindset

There are almost 1900 companies with active securities trading on the Australian Securities Exchange (ASX). There are, however, more than 4000 that have been delisted. In other words, there is a quantum of companies that have failed and, at any given time, there are a bunch still listed that are on their way to joining the 4000.

If you could simply avoid those companies that are on their way to the exit, you should substantially beat the market. If you can isolate the very best, you should beat the market by a whole lot more; and if you can buy the very best at the right price, you are most certainly going to do reasonably well.

Shares need to be treated as pieces of businesses, rather than lines that wiggle up and down on a graph. This seems pretty rational and yet professional investors might buy a company loaded with debt because its inclusion in the portfolio reduces its overall volatility.

Buying shares in the hope they will rise is not the same as buying a piece of a business. Purchasing shares on the baseless hope that there will be a capital gain is no different from betting on black or red.

The best businesses have superior economics, good prospects for sales, profits and intrinsic value, and great management. They have high rates of return on equity, driven by sustainable competitive advantages, solid cash flow and little or no debt. They are run by first-class managers who think like owners and treat their shareholders as such.

By my definition, an extraordinary business is one that meets all these criteria.

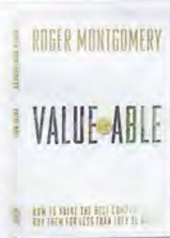
Owners or shareholders of such businesses, whether listed on the stockmarket or unlisted, tend to do very well, and you'll do well if you can fill your portfolio with these businesses too.

Many investors ask me what to do if most

of the criteria are met but not all of them. The simple answer of course is that the business is not truly extraordinary. It is human nature to fear missing out, so when we think that we can profit from an opportunity, we will be tempted to grab it despite the fact that not every box is ticked.

YOUR CHANCE TO WIN

Be one of the first five people to order and pay for your personally signed copy of *Value.able*, and have the price of one book refunded to your credit card (value $49.99, including GST and postage within Australia). Refund limited to one book per customer. Order before 5pm Friday September 30 at www.rogermontgomery.com/money



Resist temptation

The right response is to resist the temptation and wait for the next opportunity, remembering that investing is not a game where you have to swing at everything. Investing is most sensible and usually most rewarding when patience and rationality are employed, rather than emotion. Simply move on and wait until the perfect opportunity presents itself.

You won't run out of opportunities. But if you swing too often and miss, you will run out of money.

A business's economics and the performance of its management are broadly measurable by relatively simple arithmetic and by applying the *Value.able* framework. Therefore, extraordinary economics can be determined with numbers, which makes your job a lot easier.

The long-term prospects of a business are less able to be summarised with numbers. Instead, the assessment of a business's prospects for growth in sales and earnings requires some thought within the *Value.able* framework.

You will be much better positioned when you also remember that the market is not always right, so treat it as a place to buy businesses rather than a place to trade stocks, focus on value rather than price, and be prepared to take advantage of the market rather than listen to it. You will then be able to navigate your way past the companies that do not offer the best opportunity for high and relatively safe returns, because they have inferior economics, people in management who don't think like owners, or doubtful prospects.

Value.able: How to value the best stocks and buy them for less than they're worth, *by Roger Montgomery, My 2 Cents Worth Publishing, RRP $49.95*