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Money

SEPTEMBER 2011 $6.95 ISSUE 138
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It's all in the chart

Roger Montgomery explains why Woolworths is a good buy

IT'S NOT HARD TO SEE WHY COLES IS more exciting to investors than Woolworths. Coles is turning around and, coming off a lower base, is gaining ground on its dominant rival. Most investors, to their detriment, take their cues from price and, since 2007, the share price of Woolworths has produced nothing but misery. From a high of $35.05 in December 2007, the share price recently touched $23.70. I recently purchased some shares at $24 for the Montgomery [Private] Fund.

Taking advantage of folly rather than participating in it is the underlying theme of this month's column about Woolworths.

Even "experts" take their cues from prices. At an investment expo, a companion on the panel – a market commentator working for a broker – said, in essence, that Woolworths didn't have the exciting revenue and profit growth profile of a company whose shares could produce exciting returns.

But whether the company grows or doesn't, excellent returns can be produced by buying shares in companies that generate excellent returns on equity, at prices below a conservative estimate of their intrinsic value. As the chart shows, in 2007 the share price of Woolies was well above its intrinsic value – the stepped blue line. Anyone buying in 2007 would have done so without knowledge of its intrinsic value. Hoping for further price rises, they have been, understandably, disappointed.

With charts like these you have the benefit of knowing the intrinsic value and its recent direction. Since 2007, without any fanfare, the intrinsic value has risen – at precisely the same time that the share price has gone nowhere and shareholders have become impatient.

As an aside, the premium over intrinsic value paid by investors in 2007 reveals the folly of motherhood statements such as "invest for the long term" or "it's time in the market, not timing the market". Investing for a long time only makes sense if you have bought shares of extraordinary business at large discounts (not premiums) to intrinsic value.

You also will be better served by taking your cues about companies from the changes in intrinsic value, not prices. Perhaps unwittingly, even professional investors can succumb to the incessant natter associated with prices. With a chart like this one you can focus on the more important change in the value of the company.

Intrinsic value has now caught up to the price and, if current expectations for earnings materialise, the value of the company will continue rising materially just as the "experts" have given up.

Woolies has its fair share of challenges. Rolling out a big-box hardware concept – Masters Home Improvement – is no small investment. And there is the distraction of revitalising and rebranding Dick Smith.

Dick Smith grew like-for-like sales by 7.1%, and market share in 2010-11. Woolworths owns 996 supermarkets in Australia and New Zealand, 11 Thomas Dux Stores, 793 liquor outlets, 581 petrol outlets, 165 Big W stores, 390 Dick Smith stores and 282 pubs and clubs. It's maintained a superior return on its equity of more than 27%.

This is remarkable. I suspect far too much of the concern about the difficult trading conditions Woolworths is "experiencing" is a function of mediocre share performance since 2007. The intrinsic value changes, however, tell the true story and that's why you need the chart of intrinsic value plotted against price for listed companies. I couldn't invest without it.

Since 2001, Woolworths' intrinsic value has increased by more than 27% annually and I expect it might just continue growing by more than 10%. If your ethical filters allow you to buy a company that owns 11,000 poker machines, the ambivalent investor sentiment represents an opportunity. Rarely have Woolworths shares traded below intrinsic value.

Home brands, the milk price war, competition regulation and demise of Grocery Watch, are all issues to be considered by the thoughtful investor. For those who elect to invest in Woolworths, the intrinsic value is estimated to be $28.40 for 2012; the current price of $26.47 represents a discount to intrinsic value of 4%. Few businesses have its record of equity growth combined with sustained high rates of return on equity.

If your strategy is, like mine, to buy extraordinary businesses trading at discounts to intrinsic value, Woolworths offers the required combination. The only thing stopping you may be a bigger discount.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, *see www.rogermontgomery.com.*

CLOSING SHARE PRICES AS AT 19-SEP-11