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# How to find invest well in a volatile market

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**Montgomery Investment Management founder Roger Montgomery explains how to make long-term investment decisions in a volatile market.**



## Transcript

TICKY FULLERTON, PRESENTER: News Corp's AGM will no doubt raise many serious questions with shareholders, but one of them might be a more general one: how do you go about making a good investment with medium-to-long-term capital growth and reasonable dividends?

It's a particularly vexing question given all the volatility at the moment.

Joining me now is Roger Montgomery, founder of boutique firm Montgomery Investment Management.

Roger, thanks for coming in.

ROGER MONTGOMERY, MONTGOMERY INVESTMENT MGMT: That's a pleasure. Nice to be back.

TICKY FULLERTON: Now we've seen today the market is up; the fifth day in a row. Investors piling in on new hopes about Europe. What's wrong with that sort of strategy?

ROGER MONTGOMERY: Well it's in the question - the problem's in the question itself. And I heard you reading the movements in today's prices. Everyone's focused on the price. Everyone's focused on what went up today and what went down today and then we run around trying to explain why those things actually happened.

Really what we should be doing is turning the prices off, turning the market off and thinking about great businesses. If we can find terrific businesses, value them and then turn the stock market back on to see whether those prices are higher or lower than those values. And hopefully if the prices are a lot lower than the values, then we buy those businesses and we'll do very well just by doing that.

TICKY FULLERTON: How can you think long-term though? I mean, you've had particular issues with particular companies, haven't you?

ROGER MONTGOMERY: Sure. Well if you take a look at Qantas - classic example. It's very easy to distinguish a good business from a bad business if you look at the changes to that business over a long period of time.

Ten years ago Qantas earned $514 million, but investors had tipped in about $3 billion of their own equity, so they wrote out cheques of their own money to run the business and they went to the bank and borrowed another $2.5 billion. 10 years later it's earning half as much with twice as much, so investors have tipped in another $2 or $3 billion and borrowed another $2 billion. That's just a terrible business, and there's no shortage of them in Australia.

TICKY FULLERTON: Is it still a terrible business though, because at some point, presumably, Qantas becomes worth buying into? No, look at all those private equity rumours that we're about at the moment.

ROGER MONTGOMERY: Yes, yes. Well that's a particular example and there's an asset play potentially there. They've got $13 billion of fixed assets, they've $3 billion of cash. You could potentially buy the business, pay off the debt and you'd end up with the frequent flyer business for virtually nothing. So, that's a different issue.

TICKY FULLERTON: Well I ask this because I see there's an Ernst & Young report out this week talking about M&A and it says 41 per cent of Australian companies expect to make an acquisition in the next 12 months. How should that factor in for investors?

ROGER MONTGOMERY: Well, I think it's important to understand that you'll do very, very well if you buy a good quality business at a discount to its intrinsic value, even if a takeover doesn't occur.

The idea of investing on the speculation that there may be a takeover is just that, it's speculation, it's not investing. And if a takeover doesn't transpire then you're going to be disappointed and you could lose money. But there are some great businesses out there that should be taken over and there's a lot of value out there at the moment, so investors could do well out of those - that M&A activity just by sticking to great quality companies.

TICKY FULLERTON: You talk about intrinsic value, value being obvious. If you are not particularly au fait with taking apart balance sheets and putting them back together again, are you able to make that sort of assessment?

ROGER MONTGOMERY: Look, I think it's not that difficult actually. I think it's quite easy to value a business. And there's a simple formula for businesses that pay most of their earnings out as a dividend.

If you simply take the return on equity, divide it by the required return, so the return that you think is reasonable, and multiply it by the book value, you've got a valuation that's going to be pretty sensible.

In fact, for a company like - for Telstra, for example, it's been around $3 or $4 for a decade, and yet 10 years ago the share price was $7 or $8.

In fact, for a company like - for Telstra, for example, it's been around $3 or $4 for a decade, and yet 10 years ago the share price was $7 or $8.

There's a great quote from Benjamin Graham many years ago. He said in the short run the markets are a voting machine, but in the long run it's a weighing machine. In the long run, price follows value, and Telstra's value's been around $3 for 10 years. The share price has only recently caught up to it.

TICKY FULLERTON: Speaking of price and value, what about the issue of dividends because a lot of investors need a regular supply of dividends, and it's a tricky balance, isn't it, particularly when that's a retrospective thing really and we're looking at many of these companies with potentially future earnings under threat at the moment?

ROGER MONTGOMERY: Well, what we do is we qualify every single company not only based on its return on equity and its prospects for intrinsic value growth, but also on future dividend yields. And what we've discovered is that if you focus only on dividend yields at the expense of the quality of the business, you end up losing money.

A lot of people at $5 said Telstra had a great dividend yield. At $4 they said it had great dividend yields. At $3 they're saying the same thing. The key is to actually stick to quality businesses if they're throwing off lots of cash.

In Australia, with only 22 million people, what'll happen is that business will mature and what will it do with its cash? It can pay higher dividends, it can buy back shares - both of those are potentially good things.

One of the things Australian companies do a lot of though is they pay too much for acquisitions and they blow up shareholders' funds.

TICKY FULLERTON: What about the more general issue of the impact of global markets? You're not scared about China, for instance, turning down and how that could impact a lot of our listed companies.

ROGER MONTGOMERY: Oh, Ticky, it makes for great reading and it makes for interesting TV, but ultimately, you know, we've had recessions, we've had depressions, we have budget every single year and ultimately long-term investing works. The key is not to worry about these short-term factors.

We're not going to go out of business. The world isn't going to end. It will recover and sensible people will do sensible things ultimately and we'll see cheap enough prices to make a lot of money out of that have opportunity. What you should do is see volatility as an opportunity rather than as a risk.

TICKY FULLERTON: So what sort of opportunity, good opportunity has there been this year, what sort of company?

ROGER MONTGOMERY: Oh, there's been terrific businesses to buy. Cochlear had a recall and you reported on it, and they had a recall of their hearing devices.

TICKY FULLERTON: That 20 per cent drop that happened as a result.

ROGER MONTGOMERY: Well it was more than that, I think.

TICKY FULLERTON: Yes. Afterwards, yeah.

ROGER MONTGOMERY: But what actually happens is the business has actually pre-emptively recalled a product, analysts have come out and, you know, they've got nothing else to do other than to say, "Well this is going to damage their reputation."

Nothing could be further from the truth. Their competitors had recalls as well and their products actually caused pain to their patients and clients, and that's not been the case for Cochlear.

So, if you wait long enough, great quality companies - and I rank every company from A1 to C5, and pretty much anyone'll be able to do that soon. So, Cochlear was an A1 business that actually became cheap because of a short-term impact that was treated as though it was a permanent displacement of its brand and its reputation. Nothing could be further from the truth.

TICKY FULLERTON: Roger Montgomery, thank you very much for joining us today.

ROGER MONTGOMERY: That's a pleasure, Ticky.

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