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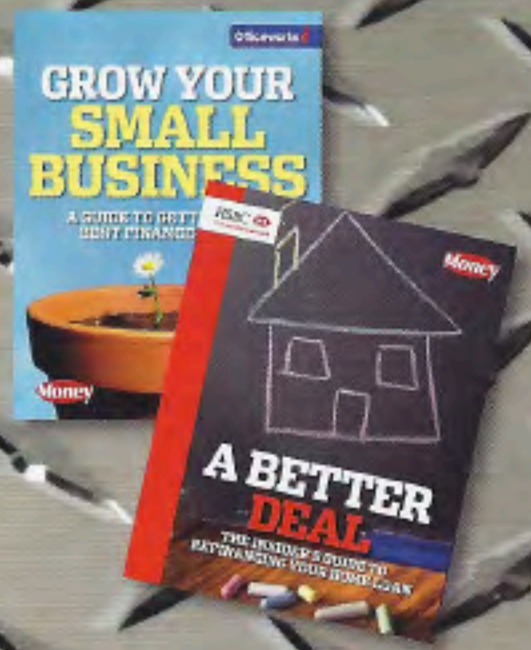

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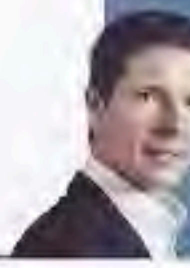

Process of elimination

Roger Montgomery does the hard work in selecting nine below-value shares

WHEN THE STOCKMARKET tide is rolling in, reporting season is a lucrative time for fund managers who have a highly systematised and automated method for collecting information and identifying companies that have reported excellent results. It has certainly been the case for us.

Fortunately for value investors, the tide is rolling out and even extraordinary business results can be ignored in preference to assessing reaction to the possibility of a Greek default or US recession or both. If either happens, even the very best companies might have more attractive share prices in coming days and weeks.

So now that reporting season is over, which companies have risen to the top in terms of meeting our *Value.able* criteria? We are looking for potentially extraordinary businesses, excellent management and bright prospects and a discount to a rational estimate of the company's true value, or intrinsic value.

Many investors find the task of sifting through the 2000-odd listed companies totally overwhelming, and if I told you that 1176 made no money last year, you might give up completely. Fortunately, that's where *Money* comes in. I have narrowed the field to nine candidates worthy of your careful attention. Instead of spending weeks turning up 1176 stones under which hide pain and suffering, I have uncovered a few that may be more rewarding – if only that market tide would start coming in.

So while 2012 could yet prove to be a challenging year for stockmarket investors, there is currently a selection of companies that appear to be both high quality and trading at prices offering a rational safety margin compared with my estimates of their intrinsic value.

The list is not exhaustive. There are other companies worth investigating, but that could prove just as overwhelming and, in any case, I want to take you through the process that I followed to arrive at these nine candidates for your investigation.

Large caps, mid caps, small caps, micro caps and nano caps were all included in the search and I included every sector and industry group.

Next, if you have been reading this column regularly, you will know that one of the things we do is give every company a quality rating. This is done completely automatically and is based on the numbers every listed company reports to the market. From A1 down to C5, the quality rating is a measure of the risk of catastrophe. An A1 company may still raise capital or have to refinance debt, but the risk of it "needing" to do so is much lower than a company with a C5 rating. I looked only at companies that earned an A1, A2 or B1 rating. That immediately narrowed the list because there are only 42 A1 companies (down from 56 in 2010), 104 A2 companies and only 14 B1-rated companies.

Then I started becoming a harder taskmaster. I wanted to include only companies for which there were analysts providing forecasts. This means there's an "independent" guide to the future that you verify yourself using any of the online brokers.

I reduced the list further by ensuring an entrant to our list offered a margin of safety – a discount to my estimate of intrinsic value of at least 5%. From over 2000 listed companies, the process produced just 27 companies. Handy, but I went even further.

An attractive and sustainable return on equity is also essential, so I narrowed the list to those that produced a ROE greater than 25% in the most recent financial year (leaving 16 stocks) and are forecast to grow their earnings per share by more than 5% (leaving 12 stocks), which in this difficult economic climate is a genuine pearl. Finally, I added the criteria that my estimate of intrinsic value must be forecast to rise at least 5%pa.

Finally, nine companies remain. These are the companies, sifted from 2000-plus entrants, that are trading at a discount to intrinsic value and that might be worthy of further investigation.

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

STOCKS THAT SURVIVED THE VALUE SIEVE

STOCK	CODE	QR[1]	ROE[2]	FC IV[3] GROWTH	COMPANY SECTOR
Seymour Whyte	SWL	A1	37.15%	22.5%	Road, bridge & concrete infrastructure development.
Medusa Mining	MML	A2	45.32%	18.0%	Copper, gold exploration & production; Philippines focus.
Nick Scali	NCK	A2	49.33%	16.7%	Furniture retailer & importer
MACA	MLD	A1	51.30%	14.9%	Contract mining & mining services; WA
M2 Telecom	MTU	A1	32.47%	13.4%	Phone system & plan supplier to SMEs
Norfolk Group	NFK	A1	26.00%	7.8%	Integrated engineering solutions – design, construction, installation & maintenance
Imdex	IMD	B1	26.40%	7.3%	Supplies drilling fluids & chemicals to energy, mining and civil sectors.
Mastermyne	MYE	B1	29.65%	6.5%	Undergound mining services – management, labour hire, equipment hire – to coalminers.
Data#3	DTL	A1	55.03%	5.6%	ICT technology and architecture solutions for business.

Ranked by forecast intrinsic value growth. [1]Montgomery Quality Rating. [2]Return on equity. [3]Forecast intrinsic value.