



Reset the compass

You can invest with confidence even if the financial system appears to be unravelling, says Roger Montgomery

LAST YEAR WAS TOUGH. IF MIDDLE East uprisings, a royal wedding, the death of Gaddafi and bin Laden, earthquakes in Japan and New Zealand and a Thai flood weren't enough to challenge the most seasoned investors, we also had to endure the collapse of Europe's financial respectability.

This year we expect to be tougher. At Montgomery Investment Management, we start 2012 with our client's capital base entirely intact, where many other managers lost money. But we think this year it will be even harder to achieve the same result without a proper framework.

My conservative nature doesn't like the fact that Australia's iron ore is building up on Chinese docks while Chinese steel mills shut for "maintenance". I don't like the fact that youth unemployment in Spain and Greece is nearing 50% while Ireland's, Italy's and Portugal's youth unemployment is at 30%. And I certainly don't like the fact that Japan's debt levels make Greece look as if it has a minor overdraft on its credit card.

That aside, none of the above considerations has any bearing on the way I invest and I believe it should have nothing to do with the way you invest. Listening to so-called "expert" prognostications about where the economy will go and what the stockmarket will do is a waste of time.

To prove it, just take a look at where the most lauded analysts in the US thought their S&P Index would end the year compared with where it actually did. According to Barrons and Bloomberg, at the beginning of 2011 Abby Joseph Cohen of Goldman Sachs forecast the S&P 500 would close the year at 1500, James Paulsen from Wells Capital said 1425, Barry Knapp of Barclays said 1420 and Henry McVey from Morgan Stanley said 1363. The S&P 500 closed 2011 at 1257. None of them got it right. And they won't this year either.

On the positive side, US manufacturing has reported its best result since June with new orders, production and employment

leading the charge. Motor vehicle demand remains strong, exports are recovering and rail traffic picked up in December. Confidence is at its best level in six months, according to Gallup Poll and Bloomberg.

The US labour market is improving, with the unemployment rate falling to the lowest level in almost three years at 8.5% and the four-week average of jobless claims declining to its lowest in three years.

In Germany, unemployment has fallen to a record low, while in China the purchasing manager's index shows continuing growth in its domestic economy and little inflation, which could lead to lower interest rates.

"Be patient. Simply wait for the perfect opportunity"

All these observations are based on facts. But another set of observations suggests more caution.

Due to tough austerity measures, Greece is in a depression. Declining tax revenue is making a major bailout more complicated. Spain is suffering a similar fate, with a massive government deficit. Hungary is on a knife edge, having just returned to the International Monetary Fund for help; in Germany, forward-looking indicators such as factory orders have plunged; and in Britain car sales are the lowest since 1994. Then you have companies such as Alcoa announcing profit downgrades, closing plants and reducing operations.

In China, home prices are plunging and Premier Wen Jiabao indicates no interest rate cuts should be expected.

Finally, in the US, another expected round of money printing will ultimately lead to inflation and reduced living standards, while Morgan Stanley has forecast



that the S&P 500 will finish the year at 1167 – down 7% from today's price.

Happily, there is a simpler way to invest and this year in *Money* I will be revealing a number of ways, including using Skaffold (see page 37), to restore confidence to your investing even when it might appear that the financial system is unravelling.

For now, here are some things to consider for 2012:

- Don't buy stocks that go up and down on a screen. Think of the stockmarket as a place to buy pieces of businesses to hold for years, rather than bits of paper that wiggle up and down each minute.
- Buy businesses that can earn returns that you can take out at the end of the year. Even if those returns aren't paid as dividends, that's OK. But you want a business that doesn't generate excess cash that must be reinvested in buying new machines or maintaining old ones.
- Be patient. Don't feel you have to do anything. Simply wait for the perfect opportunity. When Cochlear slumped more than 40% from its highs last year on the back of a product recall, another opportunity to take advantage of a short-sighted market was presented.
- Look for businesses with a competitive advantages: the ability to raise prices without detrimentally impacting sales volume, the company that is the lowest-cost provider, the company enjoying the network effect. Evidence of a competitive advantage is often found in a combination of high return on equity and little or no debt.
- Finally, don't buy a single share without rationally estimating its intrinsic value. Only consider buying when the price is well and truly below that estimate.

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