



# Stick to stocks with edge

It's all about buying great businesses at the right price, says Roger Montgomery

**I**N THE FIVE MONTHS TO DECEMBER, the strategy I will begin to reveal returned more than 18%. The Montgomery Fund's returns in a short period make the annual 4% we receive in our term deposits look paltry. No wonder Mr Stevens over at the Reserve Bank of Australia thinks we'll all be switching to shares eventually. Gosh, even Telstra is paying 9% – but they really cannot afford it.

A recent episode of *Squawkbox* on CNBC featured a panel of “renowned” sharemarket strategists and fund managers. The first expert said it was time to sell shares because analysts had overestimated earnings and the US stockmarket is about to crash. Another expert said it was time to buy, and the third thought the market would go nowhere. Add predictions of a property boom, a property crash and changes to super and you have a step-by-step plan for ... confusion.

With humility and absolutely no ability to predict whether the double-digit returns we generated for our investors over the past two years will continue, may I suggest an alternative. Your job as an investor is to purchase at a rational price, a part-share of an extraordinary business. If you can construct a portfolio of businesses bought at rational prices, with the right characteristics, whose earnings march upwards over the years, so will the market value of the

portfolio. It's that simple! Last year every commentator, expert and prognosticator told you the economy was falling off a cliff, retail sales were in the doldrums, interest rates would keep falling and house prices might collapse. And yet a bunch of companies – many of which we own in the Montgomery Fund – grew their profits by 20%, 25% or even 30%. And their shares did even better. So how can you replicate this?

It's not complicated. The best businesses are simply those able to turn a dollar of retained earnings into at least a dollar of long-term market value. Those that can do

pricing power. When he raises prices, volume goes up. It's as if his customers see the product as more valuable,

This year, I'm going to take a step back and spend the first few months in *Money* dissecting the formula that sits behind the portfolio we built and manage for our investors. You can do it yourself and you should give it a go. Of course, there's always a professionally managed fund available; just be sure to choose one that has a genuinely long-term perspective and is filled with those extraordinary businesses.

Above all, don't forget this advice: ignore the forecasters and don't be distracted from your goal by all the noise. Forecasters get it more wrong than right when it comes to market predictions. Most economists did not see the GFC coming and the majority of large-cap equity funds managers cannot beat the market. Standard & Poor's SPIVA report showed fewer than a third of Australian equity general funds outperformed the S&P/ASX 200 Accumulation index over five years to mid-2011. (Small-cap funds, and others such as Montgomery Investment Management, more recently, have done much better, but that's another story.)

Despite this miserable record, some investors hang on every word of so-called market experts, when all the evidence points to high forecasting errors, especially in volatile markets. These investors assume they must be right because the expert comes from a well-known firm, sounds knowledgeable and is persuasive. Believe me, there's a lot more sizzle than sausage when it comes to sound, reliable investment commentary over a long period.

## Forecasters get it more wrong than right

that are those that generate very high rates of return on equity with little or no debt.

In turn, they have a competitive advantage of some description. It might be the network effect, enjoyed by REA Group or Carsales, or a geographical monopoly such as enjoyed by Transurban's toll roads. But most valuable is the ability to charge a higher price for products or services without a detrimental impact on unit sales volume. In other words, when they raise their prices there's no change to the number of units they sell. My friend Nick, who owns a very successful gelato business based in Sydney but expanding globally, has this

So let's return to that line you need to stick above your desk or wherever you make buy and sell decisions: “*Your job as an investor is to simply buy an extraordinary business at a rational price.*” Next month I'll explain how to calculate that “rational” price – at the Montgomery Fund we call it “intrinsic value”. It has nothing to do with dividend yields or price-earnings ratios. It's a simple formula you cannot afford to miss.

*Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, see [www.rogermontgomery.com](http://www.rogermontgomery.com).*