Why quality comes first

Investors should back companies that will last the distance, writes Roger Montgomery

THERE ARE TWO CRITICAL dimensions to understanding an equity investment: quality and value. At Montgomery, any investment analysis needs to address both these elements and, in your own investing, you should not ignore the fact that quality comes first.

Most investors have a sound understanding of what value means, but quality is a little more elusive. This month I want to outline what we mean by quality, and why it plays such a central role in our process.

Consider two athletes running a marathon. One has an excellent level of fitness, honed over many years of disciplined training, and is running at a measured pace. The other athlete has not put in the same disciplined training but early in the race has put on a turn of speed and is outpacing the first. Which one do you back?

For a time, it's likely that the second athlete will continue to outpace the first. However, there's a good chance that at some point their stamina will fail them. There's no telling when that might happen but, as the time frame gets longer, the odds steadily shift in favour of the first runner.

In investment terms, we can think of profits or cash flows as speed. If you can buy them at a low price, then you are getting good value. However, when you are investing for the long run, you need to think about whether the speed can be maintained or, preferably, increased.

Quality is our way of thinking about how value may develop over the long run. A high-quality business is one where the value is secure (the chance of a sudden drop in value is low) and prospects for increasing value are good.

An example may be useful in demonstrating how important this can be. In the chart (right) we have set out the long-term share price for a company that we think is of high quality – ARB Corporation (ASX: ARP). Alongside it we have set out the estimated intrinsic value for ARB, as produced by one of our automated valuation models.

This analysis shows that ARB's value and price have tended to stay fairly close to one another over the years. There have been times when it has looked expensive and times when it has looked cheap, but the gap has usually been modest – with the exception of during the GFC, when the price took a somewhat unjustified beating.

This doesn't happen in all cases. For some companies there can be periods – sometimes several years – when value and price lose touch with one another. However, in the long run value and price usually get back together.

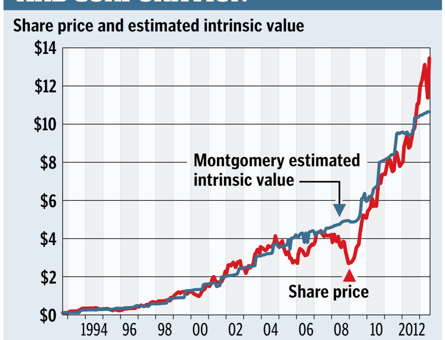
This phenomenon is the basic building block of value investing. If you can buy a company when its price is well below its value – and the value doesn't disappear – then over time the share price should rise to meet it. Seven companies that we believe harbour all the characteristics of quality that we desire are Ainsworth Game Technology, Sirtex Medical, carsales.com, Breville Group, The Reject Shop, CSL Ltd and Domino's.

Perhaps the more important observation, though, is how rising intrinsic value affects the investment dynamic. For a high-quality company such as ARB, value tends to march higher over time and this makes life much safer and easier for a patient investor. If you had bought ARB at the wrong time, you might have lost money for a while, but the solution to this problem is straightforward: simply wait a few years and the rising intrinsic value ultimately drives up the share price.

In fact, as your time horizon gets longer, the price you pay matters less and less and quality matters more and more. In the case of ARB, buying it in the early 1990s would have delivered you a return (not counting dividends) of more than 20%pa, regardless of exactly when you bought it.

At Montgomery, we take a long-term view on our investments, and so quality is something we can't ignore. We focus ruthlessly on value as well, but quality is always the first step in our process and should be in yours.

ARB CORPORATION



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