# THE SHORT CUT

with Roger Montgomery

OUR job as investors is a simple one: give our clients more dollars at the end than they had at the beginning. It's also important that we earn our clients enough new dollars to be at least as well off in the future as they are today.

You aren't doing such a great job of investing if today you have to eat at MacDonald's when, 20 years ago, you were dining at Florentino's.

In other words, the capital value of the portfolio and the income from it needs to keep pace with inflation.

There are a number of ways to put the odds in your favour. One simple way is to ensure you avoid those businesses whose operations are burdened by lots of physical assets that need maintenance and ultimately replacement.

With governments around the world continuing to print money en-masse in an attempt to inflate away debt levels, your investment portfolio will likely benefit if you choose to avoid industries and businesses which are highly capital intensive.

The second tool is to buy businesses that are the polar opposite — those that are capital-light. And finally, you should buy businesses that have the ability to raise prices for the products they sell without experiencing a detrimental impact on unit sales volume.

Capital-intensiveness is a term that was coined at the start of the industrial revolution to characterise steel and iron factories. It generally relates to businesses that employ a large portion of their capital to purchase, install and maintain expensive property, plant and equipment.

Over time, investing in any such business is, in my view, unlikely to be profitable in inflation-adjusted terms.

This is because the returns you receive being a part owner (shareholder), whether in the form of dividends or capital growth, are directly related to the amount of free cash flow that each of your individual business stakes generate over time. Your returns will also depend on how successful management is at redeploying capital, through organic growth or acquisition.

A business that is "asset light" is one that is much less capital-intensive. Think of those that aren't typically capital intensive — financial services firms (CBA, PPT), internet related companies (CRZ, REA) or those involved in healthcare (RHC, RMD).

Because of this, these businesses are capable of growing and returning funds to shareholders while investing much less in just "maintaining" operations.

An internet business, such as REA Group, owner of Realestate.com.au, is a perfect example.

The company is not required to maintain large physical assets. It's a business that's known to pay increasing dividends while also reinvesting in organic growth, such as new online features, as well as growth through acquisitions.

Take a look at REA Group's share price over the last decade for evidence of how powerful a wealth creation machine an asset-light company can be.

Contrast REA Group with any business that is heavy with assets and which must constantly reinvest in order to maintain sales figures and hold on to market share.

If prices go up, any advantage that higher sales prices bring will probably be negated because of the high-rising costs associated with bigger capital spending over time. Inflation really hurts these businesses and they really can struggle to just stand still.

Railways, for example, have extensive networks of track to install and maintain, and the trains that run along them also require major upkeep and reinvestment. It's highly unlikely 100km of rail track will cost less in the future than it does today.

These economics are not great unless the company is also a monopoly and can raise prices by even more than the additional cost associated with maintaining and replacing the assets.

Put together a portfolio of businesses that can raise prices and freely return cash flow to its owners rather than being forced to return it to the suppliers of its equipment and machinery, and the market value of that portfolio should look after itself.

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## INDUSTRIALS