Game of patience

It's essential for an investor to have the right temperament, says Roger Montgomery

IT'S A GREAT BUSINESS CHARTISTS are in. One of the more highly regarded practitioners and newsletter publishers in the US – we'll just call him John N – commented recently: "The next days and weeks will be pivotal for the market's future direction." To sound profound without actually saying anything of value is an art in itself, but what it reveals perhaps more than anything else is the lack of the right temperament for investing.

When the question of charts comes up, I have a bunch of arguments. But perhaps the simplest is to ask a chartist how they'd decide to invest in an initial public offering. Keeping in mind there is a great deal of opportunity in IPOs (but no charts), I suggest you seriously consider taking the time to understand how to identify extraordinary businesses and then value them.

If you don't want to do that, then simply outsource the job to someone adept at it and get on with enjoying the extra time you have just gained. Oh, and you won't hear me advocating index funds either. The index is made up of companies that are big but not necessarily "good". The index is widely accepted but, it suffices to say, flawed. That helps explain why it is unchanged from where it was in November 2006.

May I suggest that there are just three things an investor needs to do very well over the long run. The first ingredient is the right framework; the second an understanding of business; and, finally, a model for valuing businesses.

The framework is simple enough: approach the stockmarket not as a venue to gamble on "up" or down" but as you would a market where pieces of extraordinary businesses are for sale. Focus on businesses rather than stocks and concentrate on values rather than prices. Values move much more slowly and are more predictable and less bipolar than hyperactive prices.

An understanding of business finances can be distilled into four words: return on incremental equity. Avoid companies with more than a little debt and only invest in companies able to sustainably generate high rates of return on their capital. You will discover share prices move around in the short run but, in the long run, they will follow the value added to the business as it builds its equity quickly by retaining high proportions of profits.

Finally, the idea of buying only when a business is being offered at a cheap price assumes that the stockmarket is not always efficient (even though many experts say that it is). The market is frequently wrong and it overreacts to events that might temporarily affect prices but which have little or no bearing on the underlying businesses. How do you know when the price of a stock is cheap? You'll have to read my book *Value.able*, because there's simply not enough space to provide the tables and steps here.

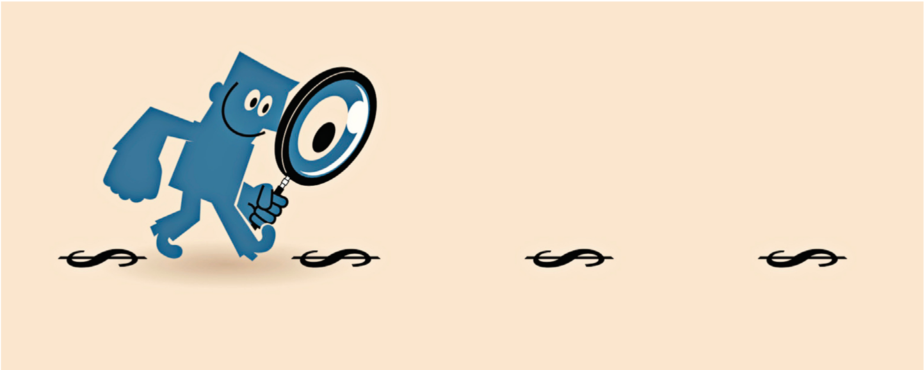
In combination, these three elements are a powerful driver of wealth creation through shares.

But there is one element I cannot teach you and it is something that can undo the great work you have done by following the other steps. It's your temperament and, more specifically, your patience.

You see, buying shares as pieces of businesses requires you to turn the stockmarket off and ignore the distracting noise of fear and hope, the confusing forecasts and the misguided opinions. You need to simply ask yourself whether the business is adding value by retaining profits and generating a high return on those profits. You need to ask whether the prospects for the business continuing to do this are good. And that's really all there is to it. The problem, of course, is that if you are in a hurry, you won't be able to turn the stockmarket off and its daily gyrating prices will tempt you to take your cue from them. But you must resist.

I will leave you with an example of the importance of the right temperament from the world's most successful investor and its wealthiest citizen, Warren Buffett. Between June 1998 and December 1999 shares of Berkshire Hathaway fell almost 35%. If that wasn't bad enough, adding insult to injury, the Dow Jones had risen 25% in exactly the same period.

In other words, Berkshire Hathaway had underperformed the market by 60%! If your fund manager underperformed by 60%, would you stick with him? No.



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Not only did Buffett's fund lose so much value, it took until November 2003 for it to regain the high of June 1998. Today the price is closing on 2½ times that high.

The reason Buffett is as wealthy as he is today is partly because he has adopted the right framework, partly because of his focus on business and on value, but mostly because he has the right temperament. And that's something you cannot chart.

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