Think profitable, not big

Look beyond the index if you want to increase your wealth, writes Roger Montgomery

WITH ALL THE INITIAL public offerings and the US market hitting new all-time highs, you'd be forgiven for thinking we are in a sweeping bull market for Australian equities. In reality, however, the Australian stockmarket – as measured by the S&P/ASX 200 – is trading back where it was in November 2006, the year cyclone Larry destroyed most of Australia's banana crop. It's enough to make any promoter of index funds, not to mention its investors, seethe with rage.

The problem is simple and, fortunately, so is the solution.

The issue with the index, and by extension investing in the index, is that it is made up of companies that are big but not necessarily good. And not many people realise that the index is a movable feast. Its constituents can and do change. S&P Dow Jones Indices, the owner of the S&P/ASX 200 Index, has an index committee that decides which companies will exit the index and which companies will be added. The decisions they make are articulated in the company's methodology.

The problem is that the indices' raison d'être is arguably not aligned with long-term businesslike investing objectives. S&P Dow Jones states: "The aim is ... to design a highly liquid and tradable index whose total market capitalisation is large enough to approximate the market segment it is capturing, while keeping the number of stocks at a minimum. This creates a highly cost-effective, easily replicable trading instrument that provides an appropriate barometer of the market's performance."

It's the descriptor "appropriate barometer" of the market performance with which a businesslike investor might take issue. You see, the index is not designed to produce the best long-term returns; the manufacturer of the index has not investigated that question. While in the US some indices require a company to have reported profits in each of the previous four quarters, in Australia there appears to be no reference at all to the requirement of being profitable before being included and maintained in an index.

GETTY IMAGES

Following on from this, long-term investors are interested in companies that grow income and add to wealth. To understand how we identify and think about these businesses in The Montgomery Fund and The Montgomery [Private] Fund requires an adjustment to one's attitude and approach to the stockmarket.

Consider, if you will, a bank account with $10 million and an interest rate of 20% forever. Also assume the bank account must distribute all the interest – $2 million – earned. If we were to auction this bank account, we would discover (with interest rates where they are) that its market value is higher than the equity deposited. In other words, it would sell for more than $10 million.

An investor with a required return of 10% could pay $20 million for this bank account, earning $2 million.

Now fast-forward 10 years.

What would the bank account trade for if we were to bring it to auction? The answer, of course, is that it could be higher or lower than the amount we would have received auctioning it today. You see, the bank account has been paying all the interest out so the equity in the bank account, even in a decade, remains stuck at $10 million – assuming, of course, you haven't made any deposits or withdrawals.

At the auction in a decade, someone may turn up with a 10% required return and be willing to pay $20 million. If interest rates are lower they may even be willing to accept a 7.5% return and pay $26.7 million. While we can make an educated guess, we simply don't know and the difference will depend on what interest rates and sentiment are doing at the time.

Consider a second bank account being auctioned today at the same event as the first. The second bank account also has $10 million deposited and earns 20% interest but all interest is retained – left invested to compound at 20%. At auction today, the account will trade for more than the equity deposited, and will also trade for more than the first account.

What we are interested in, however, is how confident we can be about what it might trade for in a decade. By then, the second bank account will have earned 20% of its balance each year, retaining that amount. After a decade of compounding, the account will have almost $62 million in it and still be earning 20%.

If we were to auction the bank account in a decade, it is reasonable to assert that not only will it sell for more than $62 million, but it will also trade for more than the price received at auction 10 years ago. The only caveat is that an irrationally exuberant price wasn't paid previously. Importantly, you can now see that real investing – the kind that produces solid returns for investors – has no business in the business of indexing.

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