Between fear and greed

Roger Montgomery searches for, and fails to find, high-quality bargains

BEFORE THE QUESTION, WHETHER the market is cheap or expensive, can be answered, it is important to understand that an expensive market doesn't automatically produce the conclusion it is going to crash. It can remain expensive for some time. Conversely, if the market looks cheap, it doesn't mean it is going to roar ahead – it could get even cheaper first.

Now that we have established that the answer to the question doesn't produce a strategy for moving ahead, we can think about is what it does tell us. The answer to the question of whether the market is cheap or expensive tells us whether it is relatively safe to invest now, for the long term.

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We'll do away with economics and issues such as unemployment rates, inflation, interest rates or gross domestic product forecasts. None of that actually matters to the serious value investor because the very best businesses can grow during the bad times, too, by taking market share from competitors or by increasing prices or margins.

So let's look at some facts, remembering that while we are going to look at the market as a whole, the object is not to bet on its direction but to determine whether now is a good time for a longer-term investor to jump in or a time to be cautious.

The S&P/ASX 200 is currently trading at the same level it was trading at in November 2006. That's almost eight years with very little capital appreciation. Of course, an investor who invested in the index in November 2006 would have received some income since then but the reward has been hardly worth the volatility that has been endured.

That's why we don't invest in the index and suggest you talk to your adviser about avoiding it too. There are simply too many big but mediocre companies influencing the index.

Companies including Qantas, Fairfax, Boral, Treasury Wine Estates, Leighton, Lend Lease and even NAB have failed to add any intrinsic value over a varying number of years when measured by our method. As a result, their share prices remain unchanged over seven years and, in some cases, more than a decade. In turn, the poor share price performance has contributed to the S&P/ASX 200's mediocre performance.

Taking the top 100 companies into our Petri dish, we discover that only three are trading at a discount to a conservative estimate of their intrinsic value. That makes the market for large companies appear expensive. If we then look to next year's valuations and ask, "How many companies will be worth more than their current price next year?", we can add five more to the list.

So under a conservative assumption about valuation and also about next year's growth in estimated valuation, the stockmarket appears to be expensive.

In the absence of good value, we might want to know whether "momentum" can be used to justify current prices. In other words, to justify the current high prices the next step is to determine if there is sufficiently good growth in earnings expected over the next year.

Surprisingly, there are more than 50 companies expected to generate earnings growth greater than 10%pa. This is a good sign. The only problem is that half these companies are of sufficiently poor quality that we would be loath to rely on them for stable earnings growth.

Indeed, only 27 remain of sufficient quality and with earnings growth that might justify premiums to their estimated intrinsic values.

That leaves me with the conclusion that now is the time to be cautiously optimistic at best. And that makes sense to us.

At the Montgomery Fund, we are holding about 22% of the fund in the safety of cash. Having cash does not mean we are forecasting a correction but it does indicate that there are very few high-quality bargains about and cash is the safest alternative, enabling the fund to take advantage of any correction should it transpire.

Typically investors rush into the market when it is making new highs and bale out when it registers deep lows. This emotionally led behaviour is the opposite to that which produces sound long-term returns.

It is best to remember the old adage that we should be fearful when others are greedy and greedy when others are fearful. Right now the hands of our particular investment clock are tilted ever so slightly towards fearful.

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