Pay the right price

A good-quality company with fine growth prospects may not be a sensible buy, writes Roger Montgomery

WHEN SEARCHING FOR GREAT stock investments whose returns will compound at high rates over time, investors often focus on finding high-quality businesses with good growth prospects.

At Montgomery we believe these conditions are absolutely necessary for successful long-term investing. But there is a third hurdle that is at least as important: that we pay the right price for the shares.

As Warren Buffett said in his most recent letter to the shareholders of Berkshire Hathaway, "a business with terrific economics can be a bad investment if it is bought for too high a price".

Let's consider the shares of Cisco Systems to illustrate the point. Cisco is the world's largest provider of computer networking gear. It was founded in 1984, is headquartered in San Jose, California, and has been listed on the Nasdaq stock exchange since 1990. (At Montgomery our quest to continually improve our investment process takes our minds far and wide – by geography and in time!) Cisco's products connect devices and provide the backbone of the internet across the globe.

Cisco has always been a high-quality business for several reasons. First, it dominates the markets for its key switching and routing products, with 60%-plus and 50% market shares respectively, and commands 40% of customer "wallet share" for overall networking spending. Cisco is very important to its customer base.

Second, Cisco has an unmatched distribution network, consisting of a large direct sales force of around 25,000 people, which is supplemented by 70,000 channel partners with more than 250,000 sales reps. These selling agents work with more than 1 million IT professionals who have been trained specifically on Cisco products.

Third, Cisco's focus on innovation provides a competitive advantage. Cisco employs 26,000 engineers and spends more than $US6 billion annually on research and development, which is almost as much as the next four competitors combined – and that is before spending another $US3 billion, on average, each year to acquire businesses that provide new technologies.

Fourth, Cisco is exposed to markets with long-term tailwinds. Demand for networking gear is underpinned by the explosion in global IP traffic, which is expected to grow at 20% annually as the world becomes ever more digitised and mobile.

Cisco's advantaged position has been remarkably persistent and has allowed the company to extract superior economics over many years. Gross profit margins have reached 70%, returns on invested capital are typically 60%-plus and free cash flow generation exceeds net income.

The attractiveness of Cisco's business fundamentals were as clear (and perhaps even clearer) 15 years ago as they are today. At that time the dotcom boom was reaching a peak and Cisco shares were trading at around $US80, which represented a whopping 150 times price-to-earnings multiple. The company had a market cap of more than $US550 billion and held the title of "most valuable company in the world". The price being paid for Cisco shares was high and investors needed to believe in very high growth rates to justify any investment.

Cisco would go on to quadruple earnings per share to more than $US2 – a robust performance but one that fell short of the expectations embedded in the minds and purchase prices of investors. Consequently the PE multiple has contracted to less than 15 times (or about 12 times after subtracting the cash held on the balance sheet) and the share price has depreciated by more than 60% to just below $US29 today.

Despite fantastic business economics, Cisco shares would have made a very bad investment because the price paid turned out to be excessive in relation to the prospects for the business.

The Cisco story from 2000 onwards provides a cringe-worthy example of the negative ramifications of failing to take heed of price when making investment decisions. Conversely, the Cisco of 2015 looks to be quite appealing for a global investor, with business economics as strong as they have always been, a positive growth outlook and a PE multiple at just one-tenth of its peak.

Meanwhile at Montgomery, we continue to weigh share prices against underlying business quality and prospects, for each potential and existing investment in our clients' portfolios to make sure we are paying the right price. The cost of paying the wrong price is just far too high.

Roger Montgomery is founder and investment head at The Montgomery Fund. For his book Value.Able, *see rogermontgomery.com.*