



Gain the edge

An investor can reap rewards by expanding their circle of competence, writes Roger Montgomery



DEFINING WHAT YOU KNOW AND what you know you don't know are critical elements of any investment decision and afford us perspective on our ability to assess the future prospects of a business. Defining these fields develops an understanding of what Warren Buffett calls our "circle of competence" – the area in which we have enough knowledge to make an educated guess about how the products and services of a business will perform in the future.

If an individual had worked, for example, in a bank for 10 years as a manager, they probably have a relatively good understanding of why the company is successful and what factors will perpetuate that success. Likewise, they probably have a good understanding of the positive and negative attributes of competitors and their prospects. So due to accumulated experience and knowledge, our banker will have an edge in the analysis of banking stocks relative to another investor without that experience.

But the same individual is unlikely to understand the prospects and technicalities of telecommunication or biotech stocks so well. Banking stocks are hence within this particular investor's circle of competence, whereas other sectors are not.

Through dedicated research, however, the circle of competence can be expanded, which will naturally increase the range of stocks in which an investor can invest.

At Montgomery we recently had this experience when researching Altium (ASX: ALU). Altium is a developer of software for the design of plastic circuit boards – the ones you can find in all electronic devices. Most investors (including myself) will agree that advanced electronic and mechanical engineering is outside their circle of competence. So how can intelligent investors expand their circle and hence evaluate a potential opportunity?

Montgomery's process was to conduct an extensive review of the company and its industry. This included discussions with a range of industry professionals (many located in the US), research houses, competing companies and customers. The aim was to understand the role of plastic circuit boards design software from the user's (an engineer's) perspective.

From this work the team was able to determine that Altium's software operates in a niche section of the design software market, notably the middle market, which is worth about \$US180 million (\$235 million) worldwide. Its software is popular among customers in this segment and has been progressively taking market share from its competitors (about 30% for the 2014 financial year). Key drivers of its popularity are its regular stream of updates and the software's overall efficient design, which improves productivity.

The cost of the software (\$US7500 for a licence and \$US1750 for a 12-month

subscription for updates) is relatively small compared with the revenues the customer will generate and yet these prices translate into attractive returns for Altium shareholders (with returns on equity of more than 100% in 2014).

Our work concluded in late January 2015 and both our funds bought into the stock at \$2.87. As the price was trading at about \$5 at the time of writing, we're pleased with the result we've delivered for our clients. In addition, by expanding our circle of competence, we have placed ourselves in a position to be able to judge the value and prospects of the stock and hence determine an appropriate exit price.

At the time of writing, we believe that the firm's value lies around \$4-\$4.50 and hence the stock is on the slightly overvalued side. Being slightly overvalued

Dedicated research increases the range of potential buys

or totally overvalued is not an uncommon characteristic in the current marketplace; however, further rises could make cash look more appealing.

Insights such as these are not only the rewards reaped by fund managers; retail investors can also do the ground work that generates these kinds of results (assuming said investors have the time for such research). Unfortunately for all investors as stock prices continue to soar, it is becoming more difficult to find these already rare opportunities.

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