Q&A with a value investor

by Roger Montgomery

Each month I chat with Peter on his show – and let me say that I believe he is working himself into the deck to bring to you the latest insights and ideas. As a result of these appearances, we sometimes receive questions that we gladly answer. Here are some answers to the more common questions we receive about value investing and the Montgomery investment philosophy.

Question: If you see the market as overvalued and most stocks you look at above their intrinsic value, do you just stay in cash until they become cheaper, even if you could be waiting years (like the 2003-2007 period)?

Answer: It is true that in theory, yes, we would have to wait years if value wasn't present. In practice, however, this is rarely, if ever, the case. First, we aren't investing in 'the market', we are investing in individual businesses and, while the broader market can be expensive, we can still be offered mouth-watering opportunities under various circumstances. This is even more true now that we will be investing globally as well as locally. Consider the recent sell off in the price of Sirtex. We had sold a meaningful portion of the fund holdings at above $32 and following the announcement of trial results, we managed to repurchase those shares at under $18. The shares subsequently rallied, in just a few weeks to over $28. All the while, the market was described as 'expensive'.

Question: I know you like stocks that pay no dividends, but what happens if management does something stupid and the stock price plummets? At least you have got something from your investment if you have received dividends.

Answer: You have misunderstood our stance on dividends, which is quite a common misunderstanding. Our position is that all things being equal, a company with a high ROE that can retain its profits and compound them at a high rate, is worth more than a company with the same ROE but paying some proportion of its earnings out as a dividend.

We are quite happy to buy companies that pay dividends but a lower price must be paid for a business that earns a high return on equity but pays more of those earnings out, rather than reinvests.

Question: What is your view of commodities? I understand that you like to value companies based on ROE, RR, etc, but do you ever try to reasonably predict the metal/commodity/gold price for next year?

Answer: While we presciently called the end of the iron boom some years before it occurred, we believe it is mostly impossible to predict prices of anything in the short term. Over longer periods, there are supply/demand considerations that might be easier to discern.

With regards to taking advantage of this, I have so far been biased to investing in the commodity itself rather than stocks. Companies that mine, plant or otherwise produce a commodity have risks associated with them that are unrelated to the commodity's price itself. For example, for an exploration company, there are funding risks and execution risks, not to mention agency risk and stock market risk.

I am loath to invest in commodity type businesses because they are the antithesis of a high quality business – one being able to raise prices in the face of excess supply, without a detrimental impact on unit sales volume.

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