Any value out there at the moment?

by Roger Montgomery

It seems to many that the year about to conclude has been a tough one for investors. On a macroeconomic level the US Federal Reserve's warnings of rate rises, followed by inaction, made uncertainty a given, while China's deepening slowdown combined with a local chase for yield, set many investors up for a painful reckoning.

But none of this should have been relevant to investors focused on quality businesses. Those investors would have held no Rio, no BHP, no Woolies and no Nab. The way to outperform the market this year has been to avoid those companies conventionally referred to as blue chips and instead buy what we refer to as the true blue chips.

Beating the market is possible, but what is required is a portfolio that looks very different to the market index.

The question you may then ask is what are the characteristics of a quality business and do any exist today that are both high quality and still representing reasonable value?

The key ingredient when determining quality is quite straightforward. You need to be invested in businesses that can retain large amounts of their profits or large amounts of equity capital, and they must be able to generate high returns on that equity capital without the need for significant debt. In short, it is far better to have a smaller business generating a high return on incremental equity than a large business that generates a low or mediocre return on equity.

Of course, it is important that these businesses can sustain those attractive rates. And that's easier said than done. High rates of return are bound to attract competition and those competitors won't rest in trying to take customers (market share) from the incumbent business. In order to stave off competitive threats, a company needs a sustainable competitive advantage. Usually that is something that isn't easily replicable. It could be reputation, geographic location, popularity (network effect) or historical cost advantages. The most valuable competitive advantage is something that gives the business the ability to charge a higher price without any detrimental impact on unit sales volume.

With those elements in mind, the following companies are worth mentioning, IPH, Magellan, iSentia, CSL, Medibank, Sirtex, Ramsay Healthcare, REA Group, Carsales and Challenger. The list, of course, is not exhaustive but it is a good start for you to begin your research.

In addition to being high quality as described above, it is also essential that the prospects for the product or service are bright. Without bright prospects, you may identify a business that only looks wonderful in the rear view mirror.

Finally, it is essential that the company's shares are trading at a treasonable price. We determine this by comparing the price to an estimate of what we believe the company is worth on a per share basis. So for every company we invest in, we estimate something called intrinsic value. You can read more about intrinsic value online or in my book *Value.able.*

The question that remains is; are there currently any companies that are both good quality and cheap?

Generally there are more opportunities than we have spotted recently. That in itself is telling – it means the market is generally expensive and at risk of weakness. Given that caveat, some of the following companies do appear to be below our estimate of their value; iSentia, REA Group, Henderson Group, Chorus and Medibank Private are some of the names that appear cheap.

Keep in mind, estimating a company's intrinsic value is not the same as predicting its share price. Even though the share price might be below our estimate of its value, that does not mean the shares are immune from declines. We cannot predict what share prices will do and that's why it's useful to ask your adviser to only buy when the shares are at very large discounts to his or her estimate of their value. Oh, and don't forget, valuations can change too. They change much more slowly than share prices but they do change. For the sort of business we want to invest in, intrinsic values should be rising over time.

Roger Montgomery is the CIO at Montgomery Investment Management and the author of Value.able.

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