Hunting for value

by Roger Montgomery

When holding cash, it is tempting to believe there was always something to buy. Sadly, because our criteria for quality and value are so high, there are days and weeks when we come into work and there is precious little investing to do.

In any event, we take some comfort from the fact that it is a mistake to believe one is adding value simply by turning up to work. That frees us up to think, read and research new ideas on which to employ cash.

Today the market is generally a little expensive and yes, it's true that high prices are a function of low interest rates, but historically paying high prices for assets generally hasn't worked out too well.

As a result, our process has been producing higher levels of cash, and we now hold about 24% of The Montgomery Fund in cash. Fortunately it hasn't hampered returns and we are pleased to have beaten the market despite a level of cash that might be considered a drag.

Cash is a terrible investment today. We're a long way from the late 1980's when earning double-digit rates from cash was possible. Today one is fortunate to achieve low single digit returns. Cash produces poor returns and cash also has a massive opportunity cost because it could be employed in businesses, which if purchased even at fair value, should produce higher long-term returns than cash.

But the 2% earned on cash is a darn sight better than minus 2%, which is also a possibility when investing in equity markets. So the way to think about cash is neither as worthy for a large part of the portfolio, nor as a long-term investment. Instead cash can be thought of as an option over lower asset prices, and an option without an expiry date nor a strike price. Cash provides flexibility.

So if you have any cash, are there any companies that we believe are reasonable quality and also reasonable value?

Looking down the list that is The Montgomery Fund's portfolio, we find that the number of high quality companies able to be purchased at a reasonable price is indeed thin. Six companies are trading at prices that, according to our method for calculating intrinsic value, still represent value.

One of those is REA Group, the owner of the realestate.com.au website is trading at a $5 discount to our estimated valuation of $65.00. In the long run, we believe the 5% share of the $6.5 billion spent on marketing residential property in Australia that REA earns will increase and the 85% that agents receive will decline.

We also know that if REA is earning 5% of the total spend to market a property, the announced 10% increase in prices for depth ads that REA will apply from July, will have no impact on its unit sales volume. If a vendor is paying a total of $30,000 to sell their house, the $1500 for a depth ad is a small percentage and a price rise of 10% to $1650, will make no difference to the decision to list on reaestate.com.au.

We also know that the company's revenue is a function of the number of ads multiplied by the time they are listed. In a boom property market, properties don't remain listed for long, if they are listed at all. In a mature market however, there is more competition (more ads) and properties take longer to sell thanks to there being more choice, and because of buyer wariness, which means listings will remain on the site for longer.

So growth will come from more listings, longer listings, a higher proportion of depth/premium ads and price rises. That sounds like growth on growth, on growth, on growth.

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