Building the Perfect Portfolio

November 2009

An investment missive by Roger Montgomery

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This article first appeared in the October 2009 issue of Money Magazine. An addendum to my original article, which appears here, is a brief explanation of how to value a company that pays all of its earnings out as a dividend. Only a handful of companies consistently pay 100% of their earnings as a dividend. Many more companies in Australia and around the world retain a portion of their profits. I suspect you will have many more questions about valuing companies and I am happy to say that most if not all your questions have been anticipated and answered in my forthcoming book. If you have not already registered to be notified of its release, go to www.RogerMontgomery.com

If you suffered heart palpitations as the stock market slumped to its nadir in early 2009 and now feel relief, you are suffering from a false sense of security. I say this not because I believe the market will decline any time soon – I have no ability to predict that – I say this because your approach to investing in shares and building a portfolio destines you to a lifetime of returns and emotions that rise and fall with the market.

It is cause for increasing dismay that despite the rise in popularity of shares and the recent crash, there has been no trend towards a rational approach to investing. And perhaps surprisingly, this is true of both seasoned professionals and part time 'investors'. Fund managers, in an effort to reduce risk, build portfolios of low covariance stocks – buying even very risky companies simply because their shares move in a different direction to all the others. Part-time investors buy shares in companies without proper research and in the hope they'll simply go up.

Shares need to be treated as pieces of businesses rather than bits of paper that wiggle up and down on a computer screen. But few do this. Witness the professional investor who buys a company loaded with debt and a manufacturer of pet rocks because its inclusion in the portfolio reduces its overall volatility. Witness the same professional who cannot buy the shares of a great business when they are truly cheap, instead having to wait until the shares have risen sufficiently to cause them to be included in the S&P/ASX200. Buying shares this way or simply buying in the hope they will rise, is not the same as buying a piece of a business.

The purchase of shares without reference to the quality or value of the business, is no different to betting on black or red. Similarly, the focus on daily quoted prices of shares encourages the treatment of the stock market as a casino. Gamblers and those who

frequent casinos tend to lose. In contrast, by treating shares as pieces of a business, you cannot help but outperform those who don't.

Whether it is because it is seen as too difficult or produces too much volatility, few investors simply purchase at attractive prices, a portfolio of 10 - 20 excellent businesses. This is despite the fact that such an approach produces substantial outperformance.[1]

Back in the June issue of ***Money*** magazine, I listed eleven stocks that I class as great businesses. The companies were Cochlear, CSL, all four major banks, Realestate.com, Woolworths, Reece, The Reject Shop and Fleetwood. Their combined return since May 26 has been 25.1 percent compared to the S&P/ASX 200 return of 21.6 percent. And the shares at the time were not even bargains. Imagine the returns if you had purchased them when they were at significant discounts to their intrinsic values back in February and March this year!

There are two steps investors need to adopt; the first is, identify superior businesses, and the second is estimate their true value.

Identifying a superior business is easy. Simply look at its economic performance and earnings power.

By way of example, suppose in the year 2000 you commenced a business with $1.9 billion of your own money and borrowed $3 billion from the bank. Also suppose at the end of that year this new business generated a profit of $520 million, representing an encouraging 25 percent return on your equity. So far, so good.

Fast–forward a decade or so and after some good years and bad years, the business this year (2009) will produce a profit of circa $120 million – roughly 75 percent less than a decade ago. Now how do you feel? I suspect you would be thinking this business isn't such a great one. Now let me heap burning coals on your head, by telling you that in

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[1] For the year to June 30, 2009, the date of my departure, the boutique funds management firm I founded and have now sold, produced a return of +11% for clients with individually managed accounts and the Listed Investment Company I founded, listed on the ASX and was Chairman and Chief Investment Officer of, produced a return of +3%. For the same period the S&P/ASX 200 Accumulation Index produced a negative return of -20.7%.

order to keep the business running, you have had to inject a further $2.8 billion of your own money and borrowed an additional $2.4 billion over the intervening ten years.

My guess is you would not be a happy business owner. You may be surprised to hear that this example is not a hypothetical one. The example is Qantas. Qantas may be an Australian Icon, it may part of our Nation's rich tapestry and way of life but a good business to own it is not. And I haven't even separated out the frequent flyer business profits.

Clearly owning [Qantas] outright has not been a wealth-creating or value-adding exercise and while the company owns a highly profitable frequent flyer program, owning the entire business would feel more like being part of a 'frequent disappointment' program!

Similar logic can be used to assess management. I want you to imagine we are going into business together and we are going to buy a retailing business. The business in our sights has $4.3 billion of equity on its balance sheet and that equity is producing a return of about 25 percent. The first question to ask ourselves, is what return should we expect or require from this investment?

We can get a 5 percent return in the bank - risk free, so we want a higher return than that because there is more risk involved in this venture than putting the cash in the bank. There's also tax to pay, stock market risk, inflation and the possibility that interest rates could go up. I would estimate we should need a return of about 13 percent.

This 'required' return or the return we reasonably want, is about half the return being produced by the equity in the business. If we require half the return being produced by the equity, we can pay double the equity. Arguably, we should pay no more than $8.3 billion dollars for this enterprise. If we pay $8.3 billion we will receive about half the return on equity. Of course, we can pay more, but the result will be a lower return. It's a very simple rule in investing; the higher the price you pay, the lower your return.

So what would you say if I told you that we were outbid by Wesfarmers in our attempt to buy the company - which is Coles by the way, and that the winning bid was $20 billion dollars excluding an additional $5 billion in renovation costs? In total Wesfarmers paid

triple what we reasonably thought Coles was worth to give us a 13 percent return. They obviously have their work cut out for them.

My guess is that you would think Wesfarmers had gone mad and that they have created a real rod for their backs. And you could be right. The near 40 percent returns on equity that Wesfarmers generated before acquiring Coles are now but a fond and distant memory. Future returns will be in the single digits for a year or two at least.

Once you embark on an examination of a business from a business owner's perspective, using equity and return on equity, you not only create a list of candidates worthy of inclusion in a portfolio but you simultaneously simplify your investment process, by creating a benchmark.

A benchmark is a line in the sand or a corral against which you compare outsiders to those things already inside. Your investment process is simplified because nothing needs to be considered unless it is better than the things already on the inside.

Many experts agree that you reduce your risk by diversifying broadly. I agree that if you buy shares in a lot of different companies whose share prices move in different directions, you will reduce the overall price volatility of your portfolio. But does it makes sense to buy shares in an inferior company simply because its share price moves in a different direction to the others that you already have? Why on earth would you ever buy shares in your twentieth best thing, when you can buy more shares in your best holding? Why cut down your roses to let the weeds through? I believe you reduce risk by only owning superior businesses.

Great businesses have high rates of return on equity, little or no debt, bright prospects and sustainable competitive advantages. A sustainable competitive advantage is the intangible thing a bout a company that the competition cannot replicate or imitate. It's the reason people will cross the street to get the product even if the guy on this side has an alternative with a lower price. It's a barrier to entry or a barrier to imitation. Ultimately, it generates the high rates of return on equity. All the companies listed earlier have high rates of return on equity. Over time such business should increase in value. And if I told you JB Hi-Fi's intrinsic value would rise substantially over the next five years, would it matter if the shares fell today?

Take the case of a company with a low rate of return on equity and little prospect of improving dramatically in the near future. Exclude it. What about a company with no debt and ten years of stable returns on equity of 30 percent? Include it. What could be simpler? Eventually you fill a corral that is a list of companies with a demonstrated track record of superior economic performance. No longer will you be tempted to dabble in the unknown, punting on whether the market will rise or fall in the next few days. Instead, you will keep a protective eye over a short list of great businesses – any of which are candidates for your portfolio if they become available at a discount to intrinsic value.

Estimating Intrinsic Value

The formula for estimating intrinsic value is just simple arithmetic. The formula is Return on Equity / Required Return X Equity Per Share = Intrinsic Value Estimate. But while the division and multiplication is simple, determining the inputs requires some thought. The basic formula compares the return generated by the business' equity to the return that an investor should reasonably expect from a business or share market investment and uses the result to determine what premium to pay for the equity. For our earlier Coles example, Equity was $4.3 billion, Return on Equity was 25 percent and the Required Return was 13 percent. The valuation formula, assuming all earnings are taken out as dividends, is 25%/13% X $4.3 billion which equals $8.3 billion.

A word of warning; don't apply this formula to a company that retains profits. If the company retains profits and generates a return on its equity that is lower than your required return, the above formula will overstate the value of the company. If the company you are examining retains profits and generates a return that is higher than your required return, the above formula will understate the value of the company.

In my forthcoming book, I reveal the steps to follow to value all companies, any company, anywhere in the world, not just those that pay out all the earnings as a dividend. While you wait for my book's release make sure you read Warren Buffett's 1981 letter to Berkshire Hathaway shareholders. You can click here to download it.

Quite simply, when the prices of shares of the companies in the corral trade below an estimate of their value, they become strong candidates for inclusion into your portfolio, investing no more than five to seven percent of your portfolio in any one of these

opportunities. And this is where the rubber hits the road. When investors forego the opportunity to buy shares in wonderful businesses because of short-term concerns about the economy or because of fears that falling prices mean risks have increased, a major opportunity is missed. Having bought shares in JB Hi-Fi below $9.00 ($18 today) and Fleetwood below $4.00 ($8.00 today), my view is that you should take advantage of other people's fears rather than listen to them. Volatility in shares prices, especially if you are a net buyer over the years, represents an opportunity rather than risk. Had I believed the widespread concerns about armageddon, I might not have made these acquisitions.

'Investing' is the laying out of money today to receive more in the future - nothing more, nothing less. The safest way to do that in the stock market is to buy shares in great businesses when they are cheap.

Shares in great businesses are cheap when they are at discount to the appropriate multiple of equity based on the profitability of that equity. High Dividend Yields or a low Price Earnings Ratio may exist, but these are not a pre-requisite to a bargain. Indeed, the way I have demonstrated the calculation of intrinsic value, a company's shares could display a high Price Earnings Ratio and a low Dividend Yield.

The rest of your time should be spent thinking about the competitive landscape a business is in to determine what pressure may be levied on its future profitability. More than perhaps anything else, you need to understand what the future return on equity is likely to be.

Finally, turn your mind to the mechanics of portfolio construction. Wouldn't it be nice if the market knew you were going to be investing a couple of million tomorrow, so fell by an appropriately substantial amount to accommodate your purchase, then returned to today's level? Unfortunately it never works out that way, but many helpers go ahead and invest all your money, all at once, as if it did! Since when is the stock market so accommodating?

The reality is that you will likely take many months to fill your portfolio with wonderful businesses, purchased at discounts to intrinsic value. But don't lose patience and don't think about stocks. If you think about stocks you'll be tempted to chase them higher and pay too much. Instead think of stocks as businesses. Business performance changes

slowly. So fill your portfolio with a selection of great businesses, like Cochlear, CSL, Woolworths, Fleetwood, and JB Hi-Fi, buying them ***only*** when they are below their intrinsic values.

Building a portfolio isn't complicated if you concentrate on great businesses bought cheap and ignore concepts like strategic and tactical asset allocation, and efficient frontiers. What could be easier than putting together a portfolio of great business, purchased at fair prices, whose earnings grow steadily over the years? Put together such a portfolio and you cannot help but do well.

Roger Montgomery
November 2009

To pre-register for Roger's upcoming book, visit www.rogermontgomery.com.