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Value Line: Best stocks, best prices

By Roger Montgomery

PORTFOLIO POINT: A sound portfolio is about buying shares in the right businesses at the right prices.

The stockmarket has a large number of opportunities at any given moment as prices rise and fall. But trying to pick day to day movements is not the same as investing. In fact it's as different as night and day, and yet this misunderstanding occurs frequently and in a variety of ways.

Consider a client who visits a financial adviser and is told to put a percentage of their portfolio in shares. They could be fully invested before lunch, with a $1 million portfolio, but is this the right way to go about it?

Over the short term, the stockmarket is merely a popularity contest but over the long term share prices tend to track business performance. That means that if you invest in the right businesses, you cannot help but do well over longer periods of time.

So rule number one for successful stockmarket investing is to think not about stocks but about businesses, and to fill your portfolio with only the best.

The second rule is based on a very simple concept: the more you pay for a stock, the lower your returns. Even if you are buying the very best businesses, pay too much and your returns will not reflect your superior business analysis.

So your job as an investor should be to buy pieces of wonderful businesses at cheap prices, own them for as long as they remain wonderful – for as long as they continue to increase in value and their prices do not get too far ahead of those values.

It's relatively easy to talk about the perfect way to build a portfolio; doing it (or indeed writing a column about it) is another matter altogether.

This is not for a lack of knowledge or business acumen. The first ingredient needed is patience: the stockmarket is no place to seek instant gratification; what prevents us from filling our portfolio with wonderful businesses at the right price is that it is rare to find everything you want at the prices you would like to pay.

So how do we do this? We'll start by listing eight businesses that we would like to own because of their superior economics, prospects and or balance sheets, along with an estimate of their intrinsic value: our price ceiling. I would prefer to allocate our funds over a larger number of companies but for now we'll stick to eight.

We will invest a portion of the funds in the eight companies with weightings determined by their current proximity to intrinsic value. I will allocate half the portfolio to this cause but then adjust down the holding based on the presence or absence of a margin of safety. The more overpriced the shares are, the less we will invest.

The one exception will be JB Hi-Fi, which is trading at a discount to its estimate of value. We'll invest an eighth of the portfolio in this company immediately, despite my personal

The Value Line portfolio, at July 7, 2009.

Company	ASX	Jul-01	Today	Est. Value	Safety margin*	Number bought	Dividends received	Total Return
JB Hi Fi	JBH	14.8	14.39	17.68	22.86%	845	—	—
The Reject Shop	TRS	11.62	11.6	11.45	-1.29%	531	—	—
Westpac Banking Corp.	WBC	19.68	19.1	18.13	-5.08%	301	—	—
Woolworths	WOW	26.16	26.27	22.86	-12.98%	208	—	—
Cochlear	COH	56.36	56.35	48.7	-13.58%	96	—	—
CSL	CSL	31.81	30.63	25.18	-17.79%	162	—	—
Reece	REH	17.8	18	12.81	-28.83%	250	—	—
Platinum Asset Management	PTM	4.06	3.9	2.18	-44.10%	860	—	—
Under observation								
ISOFT	ISF	0.635	0.645	0.038	-94.11%	—	—	—
Amcor	AMC	4.79	4.69	2.66	-43.28%	—	—	—
Security Value								**$48,521.44**
Cash Value								$51,478.56
Total Value								**$100,000.00**

** The safety margin is the difference between the price of the security and its valuation.*

view that the market seems a tad expensive overall and for all the so-called “green shoots”, the economy still resembles a scorched forest.

If the company valuation rises or the price falls below our listed valuations – after an earnings report, for example – we’ll add to the portfolio using the cash we have on the sidelines. This will reflect a purist approach to value investing and my preferred approach: only buy quality and only when well below intrinsic value.

At the end of the year we will be able to break down the returns from the 50% invested immediately in businesses with superior economics, the funds invested in only those companies acquired at a discount to our estimate of their intrinsic value, and the total portfolio.

We will also list two companies that we believe meet none of the previously stated criteria. That is, they are neither great quality businesses nor trading at cheap prices. We’ll call them expensive and poor. We won’t short-sell them because the risks are asymmetric, something I will discuss in coming weeks. We’ll just keep an eye on them and hopefully learn something about the benefits of avoiding expensive companies with inferior economics.

Now, a few warnings. First, do not expect a smooth ride. Because we are buying eight companies, the performance of our portfolio will be much more volatile than the market.

Many of you will think this means that the portfolio is more risky. But volatility, for our purposes, is not a measure of risk. Indeed, if the shares of great businesses were to fall spectacularly then, provided they remained great businesses, the fall would represent an opportunity rather than a risk.

The second warning is that if we happen to outperform in the first year, I will be thrilled but surprised. Stockmarkets do produce negative returns over the short term, but over the long term they outperform every other asset class. If you want certain and smooth one-year returns, try a term deposit because the stockmarket is not the place for you.

Finally, a personal observation: the market looks expensive at the moment. I can’t see a great deal of value among the high-quality companies and so I expect the portfolio to reflect that in its early stages.

Valuing a company is not the same as predicting its share price performance. Valuations are based on the economic performance of the business but share prices are determined by the rising and falling tides of sentiment.

You can put your finger on business performance but not on popular sentiment. However, my own investment performance has not required me to be any good at telling the future, and over long periods of time you just need to get the businesses and their valuations right, not the stockmarket.

So here is our initial list, which of course we reserve the right to change at a moment’s notice. Next week we’ll begin the process of explaining the choices and their valuations. ◆

A Eureka Report contributor for many years, Roger Montgomery founded, floated, sold and retired from a Sydney based funds management company. He is currently spending a year as an independent analyst and strategist focusing on his private investment interests.