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Value Line: ASX and Telstra

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PORTFOLIO POINT: ASX used to be a wonderful business but is now expensive. Telstra is not as expensive, nor is it wonderful.

I'm often asked about why I didn't include this or that stock in the portfolio. I'm also asked about the lack of turnover. The truth is that while a very wide net was cast in its construction, only a select few stocks exhibited the qualities I would feel comfortable investing in.

As we approach the end of reporting season, this is becoming more apparent. There were no companies that went from mediocre to outstanding, in terms of either their quality or long-term prospects, while also being good value.

Furthermore, those companies that delivered poor results weren't in the portfolio to begin with. I might add I am in no rush to add them in the future, either. And restricting myself to just eight stocks means I cannot add any more without ditching some that I have already selected.

One of the first companies that investors think about when asked to identify those with monopoly characteristics and structural competitive advantages – for example, due to regulation, "virtuous weaves" or high switching costs – is the Australian Securities Exchange. The ASX is a company whose shares I have owned in the past and one to which some of my peers can attribute a large portion of their wealth.

There is no doubt it is a toll bridge-style monopoly. There is no doubt that switching costs for customers are prohibitively high – where else would Westfield go to have its shares traded? There is no doubt the business has been strengthened by the presence of what I like to call the virtuous weave, a name I give, in this case, for the cycle of more stocks listing, leading to more traders trading, leading to more stocks listing and so on. Further, there is little doubt that the exchange could cope with much higher volumes without a commensurate increase in capital expenditure.

But these generators of franchise-strength competitive advantages are only beneficial if they translate into high returns on equity and while for a very long time the ASX could demonstrate such returns, today's ASX cannot. Once the ASX's return on equity was close to 40%, but today it sits slightly above 12%. You might ask how a regulated monopoly with the features I just described generate such a low return on equity?

Value Line portfolio, as at August 25, 2009

Company	ASX	July 1 price	Price today	Est value	Margin of safety	Shares purchased	Invested capital ($)	Capital value ($)	Divs rec	Total return	Total return
JB Hi Fi	JBH	14.8	17.79	**21.70**	18.0%	845	$12,500	$15,025	0.29	$2,770	22.16%
Cochlear	COH	56.36	59.11	**58.70**	-0.7%	102	$5,744	$6,024	0	$280	4.88%
CSL	CSL	31.81	32.21	**28.99**	-11.1%	163	$5,197	$5,263	0	$65	1.26%
The Reject Shop	TRS	11.62	13.29	**11.27**	-17.9%	513	$5,959	$6,815	0	$856	14.37%
Woolworths	WOW	26.16	28.63	22.86	-25.2%	206	$5,377	$5,885	0	$508	9.44%
Westpac	WBC	19.68	23.76	18.13	-31.1%	295	$5,811	$7,016	0	$1,205	20.73%
Reece	REH	17.8	22	12.81	-71.7%	236	$4,209	$5,203	0	$993	23.60%
Platinum Asset Mgt	PTM	4.06	4.97	**2.84**	-75.0%	854	$3,467	$4,244	0.12	$880	25.37%

Since July 1	Average 15.23%
Security Value	$55,474
Cash Value	$51,736
Total Value	$107,210
Total Return ($)	$7,557.43
Return Invested (%)	15.66%
Total Return (%)	7.56%
XAO Change	11.90%

* Outperformance (I): Outperformance of Invested Portion	3.76%
* Outperformance (T): Outperformance of total portfolio	-4.34%

Under observation											
ISOFT	ISF	0.635	0.84	0.038	-2110.5%						-32.28%
Amcor	AMC	4.79	5.47	2.66	-105.6%						-14.20%

The answer lies in another exchange. Specifically, the overpayment for the "merger" with the Sydney Futures Exchange (SFE). When too much is paid for an acquisition, even the best company can falter.

At the end of 2006-07, the equity capital of the ASX rose from less than $500 million to more than $2.5 billion, the result of the ASX issuing 0.51 shares for every SFE share to acquire the SFE. The price paid was equivalent to $2.4 billion or almost $18 per share – a far cry from the share price of about $2.30 you would pay in 2004. Return on equity promptly slumped.

But it wasn't all bad news. According to the public statements at the time, there would be cost savings from synergies: back office and settlement function duplication would be removed and IT spending could benefit from volume-related improvements to buying terms. So what actually happened? In short, return on equity slumped after the "merger" but the synergy benefits that should have seen the figure start to recover have not emerged, offset by recent economic events and lower margins on the very large capital raisings. And, after all that, the shares at almost $34 are trading well above my estimate of their intrinsic value of between $25 and $28.

The other near miss to the Value Line portfolio is Telstra. Unlike the ASX, a company that was once a wonderful business and is now expensive, Telstra is not as expensive but nor is it a wonderful business.

I must confess, however, that despite its mediocre attributes, I previously owned Telstra shares, buying into T3, which was an example of a mediocre company issuing a very attractive piece of paper. The shares today are the subject of what is known as rotational buying – fund manager speak for buying into things that have not gone up as much as others. Very scientific, don't you think? But that's what you get when you have more funds than there are stocks.

In all seriousness, Telstra shares do look cheap and I have a valuation of $4.01 but this is a business that is currently earning the same profit that is was earning at the turn of the century, whose return on equity is still not back to where it was a decade ago and whose rising return on equity is due to equity falling rather than profit growth. This latter fact stems from the policy of paying dividends far in excess of profits. Moreover, the company is a capital-intensive one – just look at the $24 billion of property, plant and equipment on the balance sheet. Further, borrowings of $17 billion are well in excess of the $12 billion in equity, which in turn is boosted by $8.4 billion of intangibles, a combination I simply prefer to avoid.

Having said all that, the shares might simply go up. To those who buy or have bought the shares I hope they rise, but don't call yourself a Buffett-style investor.

With all that to digest, I will leave the discussion about revised valuations and changes in the portfolio for next week. Reporting season is always a busy time for analysts and fund managers. I have made some company valuation changes in light of the recent full-year results (bolded in the table). This has prompted me to make a change in the portfolio due to the large premium to intrinsic value, which I will reveal in more detail next week. ◆

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