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**How to pick great stocks**

These four rules are the secret of successful value investing

**By Roger Montgomery**

Have you made money in the recovery so far from the global financial crisis? Congratulations may be in order but back-slapping is only truly due if you have changed your approach to investing in such a way that you are no longer destined to a lifetime of returns and emotions that rise and fall with the market.

There are 2081 active securities trading on ASX at present. More than 4000 have been delisted over time. In other words, there is a huge number of companies that have failed and at any given time there are a bunch still listed that are on their way to joining them.

If you could simply avoid those companies that are on their way to the exit, you should substantially beat the market. If you can isolate the very best, you should beat the market by a whole lot more. And if you can buy the very best at the right price, you are most certainly going to do reasonably well.

I offer four suggestions for making sure that the current optimism does not cloud your judgment and to ensure you know precisely when you have overstayed the party:

1. Treat shares not as bits of paper that wiggle on a screen, but as pieces of businesses.
2. The business boat you get into is far more important than who is rowing it.
3. Learn to identify great businesses.
4. Only buy into companies when they are below their intrinsic value.

It is cause for increasing dismay that despite the recent crash there has been no trend towards a rational approach to investing. And, perhaps surprisingly, this is true of seasoned professionals and part-time investors alike.

**It's a business, right?**

Take my first point: shares need to be treated as pieces of businesses rather than bits of changing data on a computer screen. This seems pretty rational, yet professional investors might buy a company loaded with debt and a manufacturer of pet rocks because its inclusion in the portfolio reduces its overall volatility.

The same professional might not buy the shares of a great business when they are truly cheap, instead waiting until the shares have risen sufficiently to cause them to be included in the S&P/ASX 200. 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 on a baseless hope for a capital gain is no different to betting on black or red at the casino.

Perhaps because it is seen as too difficult, few investors simply purchase at attractive prices a portfolio of 10 to 20 excellent businesses. This is despite the fact that such an approach produces substantial outperformance.

To prove that quality counts, in the June issue of *Money* magazine I listed 11 shares - Cochlear, CSL, all four major banks, Realestate.com, Woolworths, Reece, The Reject Shop and Fleetwood. Their combined return since July 1 has been 30 per cent compared with the S&P/ASX 200 accumulation index return of 24 per cent. Four of those companies have risen by more than 40 per cent in that time.

In July I also commenced a portfolio of eight shares, which included JB HiFi and Platinum Asset Management. An equally weighted portfolio invested in those eight shares would have risen by 27 per cent and Platinum is up by more than 53 per cent.

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.

**Superior business value**

There are really only two steps you need to adopt: first, learn to identify superior businesses; second, learn to estimate their true value. Identifying a superior business is easy: simply look at its economic performance and earnings power.

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

Fast-forward, and after some good years and bad years, the business this year (2009) will produce a profit of just $117 million - 77 per cent less than a decade ago. Now how do you feel? I suspect you would be thinking the business is not such a great one.

Now let me heap burning coals on your head by telling you that 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 10 years.

You may be surprised to know that is not a hypothetical example. The business is Qantas.

**The business/management equation**

Earlier, in my second main point, I said the business is more important than management. If the boat is perpetually leaking, even the world's best coxswain cannot steer it to a happy ending. But inferior management decisions can steer a boat to disaster.

Imagine we are going into business together and we are going to buy a retailer. The business in our sights has $4 billion of equity on its balance sheet and that equity is producing a return of about 25 per cent. Because we can get 5 per cent in the bank, we should require a higher return from 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 for this enterprise. If we were great retailers, perhaps we could stretch the purchase price to $9 billion or even $10 billion.

So what is your reaction when I tell you that, again, this is a real business - Wesfarmers - and it was bought by a listed company for $20 billion - excluding an additional $5 billion in renovation costs? My guess is you think the management paid way too much. You could be right. The almost 40 per cent returns on equity that the buyers were generating before acquisition are now a distant memory. Future returns will be in single digits for some time.

**Create a worthy list**

Once you embark on an examination of businesses rather than shares, from a business owner's perspective, using equity and return on equity, you can simply create a list of candidates worthy of inclusion in a portfolio.

Great businesses have high rates of return on equity, little or no debt, bright prospects and sustainable competitive advantages. Over longer periods of time and notwithstanding black swans, such a business should increase in value. And you can boost your returns if you buy lots of shares when they are at substantial discounts to intrinsic value.

The formula for estimating intrinsic value is just simple arithmetic. The valuation formula, assuming all earnings are taken out as dividends is:

*Return on equity divided by your required return multiplied by equity. Then divide the answer by the number of shares on issue.*

Run the formula over any company in your portfolio that pays most of its earnings as a dividend. You may be in for a rude awakening.

Shares in great businesses are cheap when they are at a discount to the appropriate multiple of equity based on the profitability of that equity. High dividend yields or low price-earnings ratios may exist but these are not a prerequisite 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.

Do not forego the opportunity to buy shares in wonderful businesses because of short-term concerns about the economy or fears that falling prices mean risks have increased. Having bought shares in JB HiFi below $9 ($18 today) and Fleetwood below $4 ($8 today), my view is that you should take advantage of other people's fears rather than listen to them.

**About the author**

Roger Montgomery b.Comm., SF Fin. is the founder and former managing director of a Sydney-based boutique funds management firm that he floated on the ASX and sold.  During the global financial crisis his firm beat the market by 33 per cent.  Since resigning in June, he has been described by Alan Kohler as "One of the nations smartest and most successful value investors" and his forthcoming book will reveal how you can do it too.  To secure a copy you must [pre-register](http://www.rogermontgomery.com/).

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