

ValueLine: Three golden rules



By Roger Montgomery

PORTFOLIO POINT: Three rules of value investing, once learned and applied, never need change.

Never underestimate the power of pride to blind us. I am speaking of course of the parable of the duck who, preening herself on the pond and noticing herself rising in the world, failed to notice the water level was rising and lifting all the other ducks with it.

With the market swinging from being wildly underpriced to mildly overpriced, there has been no shortage of opportunities with which to do well.

Even choosing stocks blindfolded would have turned up a few winners. With this in mind, it should come as no surprise that a fund manager with some understanding of business microeconomics and sensible approach to valuation will

manage to pick a few winners and also avoid a few losers.

Now, you may recall that in ValueLine this year I ran three portfolios (or strategies), each with a different combination of stocks and cash.

The first was fully invested on day one; not quite the “Blind Freddy” approach because the ValueLine universe consisted only of high-quality businesses and with equally handy management teams. The portfolio was also overweight any companies that were also trading at a discount to my estimate of intrinsic value.

This portfolio only made three changes in six months: selling The Reject Shop; then selling Westpac; and switching into CBA. The Reject Shop then went down. Although Westpac went up, it didn’t go up as much as CBA.

The performance of this portfolio from July 1 to December 18 was fraction under 30%, or an annualised rate of 60%.

Six months is too short a time to make any conclusions but I have been doing this for a lot longer so the above performance is further evidence that buying high-quality businesses works. Even if you pay over the odds in terms of price, which increases risk, you will beat a rising market if you only stick to quality issues.

Jeremy Grantham, the famed founder of GMO and manager of \$US102 billion, recently observed: “In the long run,

The ValueLine portfolio, as at December 22, 2009

Company	Buy price	Price today	Est value	Margin of safety	Shares bought	Invested	Capital value	Divs rec	Total return	Total return
JB Hi-Fi	14.8	23.34	25.76	9.4%	845	\$12,500	\$19,713	0.29	\$7,458	59.66%
Cochlear	56.36	67.36	56.3	-19.6%	102	\$5,744	\$6,865	0.95	\$1,218	21.20%
CSL	31.81	30.38	32.87	7.6%	163	\$5,197	\$4,964	0.4	-\$168	-3.24%
Woolworths	26.16	26.6	26.85	0.9%	206	\$5,377	\$5,468	0.56	\$206	3.82%
Reece	17.8	24.1	14.83	-62.5%	236	\$4,209	\$5,699	0.33	\$1,568	37.25%
Platinum Asset Mgt	4.06	5.05	3.95	-27.8%	854	\$3,467	\$4,312	0.12	\$948	27.34%
CommBank	46.51	52.86	52.81	-0.1%	215	\$10,000	\$11,365	0	\$1,365	13.65%

Since July 1

Security Value	\$58,386
Cash Value	\$56,635
Total Value	\$115,021
Total Return (\$)	\$15,020.78
Return Invested (%)	+29.25%
Total Return (%)	+15.02%
All Ordinaries change	+17.05%
Outperformance of invested portion	+12.20%
Outperformance of total portfolio	-2.03%

Negative watch

Company	July 1 price	Price today	Est value	Margin of safety	Divs rec	Total return
ISOFT	0.635	0.73	0.19	-284.2%	0	14.96%
Amcor	4.79	6.04	3.63	-66.4%	0	26.10%

quality stocks have proven to be the one free lunch . . . quality stocks have slightly outperformed the market for the last 40 years.”

The second portfolio invested only in the companies that were trading at a discount to intrinsic value. That was JB Hi-Fi when the portfolio commenced and then CBA later in the year. The return from investing in these two stocks was 35.4% for the six months, or an annualised rate of 71%.

The second portfolio has again shown me that if buying a portfolio of quality stocks beats the benchmark index over time (and this shouldn't be difficult if you remember there are a lot of low-quality stocks in the benchmark that are easy to identify and exclude), you can really supercharge your returns by buying those quality issues when they are below intrinsic value.

Not only do you receive the benefit of the superior economic performance of the business, but you also receive the benefit of receiving more in value than you pay in price. Under this combination of features and a rising market, you cannot help but produce great results.

The third portfolio was a hybrid of the first and second: investing half of the initial capital cross all eight stocks, overweighting exposure to the underpriced stocks and keeping half in cash.

The cash component of the portfolio quite clearly held back its performance. Its performance for the six months to December 18 was 16.9% – a slight but nevertheless significant underperformance compared to the benchmark's 18.3% for the six months. Cash wasn't a good place to be over the past six months.

The third portfolio has taught me that in a rising market, cash looks awful but much like our duck, the hubris associated with a rising market blinds investors to risk. If over time you can do as well or better than the duck and with cash in the bank, you are doing frightfully well.

ValueLine represents the practical application of a stream of value investing that is frequently referred to far less frequently adopted despite the ease with which it can be applied. There are three basic principles that once understood and accepted, need never change.

■ Don't think of the market as a place to make bets on which stocks will up and which stocks will go down. Think of it as a place to buy slices of only the best quality businesses.

■ Understand what differentiates a good quality business from a mediocre one.

■ Learn how to value these businesses and buy them at price well below a conservative estimate of that value.

If you follow these three basic investing principles they will produce proceeds you can live with and a long list of companies you can live without.

I hope ValueLine has taught you something about the process of value investing this year. Enjoying the proceeds is much easier.

Happy Christmas to you and those dearest to you. See in you again in the new year. ◆

Roger Montgomery is an independent analyst and managing director at rogermontgomery.com.