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ValueLine: Investing's first step

By Roger Montgomery

PORTFOLIO POINT: Successful investing means identifying sound businesses and buying them for the right price. It's a world (and just three steps) away from speculating.

With memories of your holiday fading fast, thoughts quickly turn to the hordes of returning bankers, brokers and economists.

As they arrive at their desks to gear up for the 2009 half-year reporting season, they face interest rate expectations and inflation concerns. They anticipate consolidation, merger and acquisition activity in the resources and financial services sectors and your summer day-dreaming is about to be replaced with an onslaught of opinions, views, tips and recommendations.

But, before you launch into another year of chasing yesterday's news, the latest sure thing and start repeating last year's mistakes … join me for three weeks of preparation. It will only take three weeks, because there are only three steps.

- **Step 1** requires you to change the way you think about and approach the market, which we will address during the course of today's column.
- **Step 2** concerns itself with understanding the difference between a great business and a mediocre one, so that you are able to identify and purchase a superior business while avoiding an inferior business. Successful investing is as much about the protection of capital as it is about making it.
- **Step 3** involves estimating the true or intrinsic value of those economically superior business. Every business and every share of a business has a value: the amount it is truly worth.

This value or worth changes slowly, much more slowly than the price of the business, which you are able to track via the sharemarket. You should never confuse the true value of a business with its current price.

There are two broad paths to approach the market. One is called investing and provided you are not in too much of a hurry, you can do very well with it. The other is known as speculating and many people who believe they are investing are actually speculating.

The ValueLine portfolio, as at January 12, 2010

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	20.93	25.76	18.8%	845	$12,500	$17,677	0.29	$5,422	43.38%
Cochlear	56.36	65.6	56.3	-16.5%	102	$5,744	$6,686	0.95	$1,039	18.08%
CSL	31.81	31.89	32.87	3.0%	163	$5,197	$5,210	0.4	$78	1.51%
Woolworths	26.16	27.79	26.85	-3.5%	206	$5,377	$5,712	0.56	$450	8.37%
Reece	17.8	24.5	14.83	-65.2%	236	$4,209	$5,794	0.33	$1,662	39.49%
Platinum Asset Mgt	4.06	5.85	3.95	-48.1%	854	$3,467	$4,995	0.12	$1,631	47.04%
CommBank	46.51	56.57	52.81	-7.1%	215	$10,000	$12,163	0	$2,163	21.63%
Since July 1, 2009										
Security Value										$58,238
Cash Value										$56,635
Total Value										$114,873
Total Return ($)										$14,872.64
Return Invested (%)										29.74%
Total Return (%)										14.87%
All Ordinaries change										15.09%
Outperformance of invested portion										14.65%
Outperformance of total portfolio										-0.22%

Negative watch

Company	July 1 price	Price today	Est value	Margin of safety	Divs rec	Total return
ISOFT	0.635	0.755	0.19	-297.4%		18.90%
Amcor	4.79	6.32	3.63	-74.1%		31.94%

The two activities are about as different as night and day.

When you are speculating it is all about the share price. Shares are seen as bits of paper available for rent. People buy them because they hope the underlying business will be taken over, that it will find oil, win a contract or make a medical breakthrough. This is the same person who buys defensives or switches to cyclicals, who rotates from small cap industrials to large cap financials in the hope that the next price wiggle will be up and they can sell tomorrow or next week or next month at a higher price.

But this is akin to betting on black. It is not investing.

Because of this haphazard approach, the prices people are prepared to pay for a stock change all the time, even though the value of the underlying business does not. The rapid nature of price changes in turn has produced an entire industry.

Watch the business news tonight and I guarantee you will see many references to changes in price since yesterday, since last year and since the stock was listed. You will also read about the price another company is prepared to pay for its takeover target and the price of particular commodities, bonds and currencies. You will hear very little – if any – talk about what the true value of the business is and how it has changed.

This regurgitation of data about the changes in price at the expense of any discussion about value, cannot help but influence you into thinking that the study of price changes is essential to becoming a successful investor. It's not.

So now you can relax, cease the incessant price updates from the media and begin to think patiently, calmly and rationally about businesses. Don't worry about stocks. Concern yourself with the mechanics of businesses.

If you were going to buy a farm today or a franchise, what would you focus on? You would focus on the carrying capacity of the land or the level of foot traffic the store is exposed to. You might concern yourself with the last time the land received fertiliser or the store received a makeover. You would ask about revenues and profits and how they have changed over the years.

You would not be thinking about how much you could flip the farm or shop for in six or 12 or 18 months – unless you were in private equity.

If you approach the stockmarket with the same values as you would approach the purchase of an unlisted business, you are well on the way to becoming an investor. ◆

Next week: How to avoid inferior businesses.

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