

Golden rules for all seasons

Barbara Drury gives some expert advice on selecting safe shares for the long haul with Warren Buffett's help.

One lesson from the financial crisis of 2008 is that there's no such thing as a guaranteed return from shares. But if there's one thing investors learnt from the sharemarket rebound in 2009, it's that you have to be in it to win it. Confused?

If you've been hovering on the sidelines wanting to start a share portfolio but are not sure how to select safe stocks for the long haul, then one source of inspiration is the world's most successful long-term investor, Warren Buffett. Faced with a volatile and uncertain market outlook, what would Warren do?

To answer that question, Money did the next best thing and spoke to five experts whose job it is to select market-beating long-term share investments.

The chief executive at Lincoln, Elio D'Amato, says the thing that sets Buffett apart is that he looks for great businesses that will be around tomorrow, with sources of revenue that will provide profits for the long term and management that can deliver.

Value investor Roger Montgomery aims to replicate Buffett's methods of stock valuation and selection.

"The first thing you should do is dismiss conventional notions of blue-chip stocks," Montgomery says.

Montgomery says the term "blue chip" is commonly used to describe large companies, such as Foster's, that Buffett wouldn't go near because they don't produce high returns on equity.

Return on equity measures how much profit a company generates with the funds shareholders have invested. In other words, big is not necessarily best.

COMPETITIVE ADVANTAGE

Montgomery says investors should do what Buffett does and buy companies with little or no debt and high rates of return on equity driven by a sustainable competitive advantage that allows them to charge more without affecting sales adversely.

The developer of the Conscious Investor stock-picking software, which is based on Buffett's rules, John Price, agrees.

"For medium- to long-term value, we need to look for companies that have a clear competitive advantage, stable growth in sales and earnings and not too much debt," Price says. "Then let management grow the business for you. Over time, the sharemarket will recognise the growing value of the business [and the share price will rise]."

"Successful companies need something about them, such as a brand name or patents and licences, that will hold them in good stead. The strength of this economic moat gives such stocks more of a flavour of bonds where returns are guaranteed."

After crunching the numbers, Price selects Billabong, with its large collection of lifestyle brand names; bionic ear developer Cochlear, with its range of valuable patents and licences; ARB, for the proven reliability of its four-wheel-drive accessories and other products; Fleetwood, which supplies homes for retirees and the resources industry; and Wridgways, which has a trusted name in removals locally and overseas.

Price says all five stocks are reasonably priced with businesses poised to grow. While paying a fair price is important, even for the best-run companies, he

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argues that the price you pay for shares becomes less important if you take a long-term view.

This is because prices can be volatile in the short-term, as the market overreacts to positive and negative news, but over the long term prices tend to reflect the companies' intrinsic value.

"If earnings double over the next five years then the share price will double too," Price says.



But that doesn't mean you should pay any price for a great company.

GROWTH PROSPECTS

"You need to pay below intrinsic value to give yourself a margin of safety and only buy businesses whose intrinsic value is rising over time," Montgomery says.

"That doesn't happen often but be quick to buy when it does."

That said, three of his picks – JB Hi-Fi, blood plasma group CSL and Cochlear – are no longer trading at a discount but he expects their intrinsic value to increase solidly in the next few years.

Shares in salary-packaging specialist McMillan Shakespeare have been marked down in recent weeks due to speculation about the impact on the group of the Henry Tax Review. This could present a buying opportunity for long-term investors. With its market domination, strong cash flow, high return on equity and no debt to speak of, Montgomery says its market value will rise in the next few years.

Montgomery says the classic example of entrenched competitive advantage is Australia's big four banks. They can and do increase their fees and charges, secure in the knowledge that few customers will walk because changing accounts and direct debits is so much hassle.

Montgomery says Commonwealth Bank stands out thanks to its opportunistic purchase of BankWest. By comparison, some of its competitors raised so much equity during the crisis that they diluted their returns. Commonwealth has a forecast return on equity of about 22 per cent this financial year, compared with 11 per cent to 13 per cent for Westpac, NAB and ANZ.

Montgomery is also a long-time fan of JB Hi-Fi, which has entrenched its position as the cheapest provider of electronics to its insatiable target market of young adults.

"Its gross profit margin is declining because it cuts prices to knock out the competition but its net profit margin keeps going up because it runs the business on the smell of an oily rag," Montgomery says. "It's what's called a profit loop."

JB Hi-Fi's success has also made it a preferred tenant at Westfield shopping centres, reinforcing the virtuous cycle.

Dividends ... despite a volatile and uncertain market outlook, patience can pay off handsomely. Illustration: Karl Hilzinger

year compared with the 9.7 per cent return from the All Ordinaries Accumulation Index (which measures capital growth plus dividends).

"We aim to buy good stocks and hold them permanently but sometimes there is reason to sell; companies get taken over, for instance, and then you need to buy something else," Argo's managing director, Rob Patterson, says. He says the important thing for investors who want to pick their own stocks (rather than buy shares in a listed investment company or units in a managed fund) is to diversify shareholdings across different market sectors.

"No one knows what the future holds so if you want to pick stocks you need at least 10 to cover your bases," he says.

Lachlan Partners' chief investment officer, Paul Saliba, also aims to deliver a diversified long-term share portfolio for clients not necessarily shooting for the stars but who want good, solid growth with income. But that doesn't necessarily mean set and forget.

Saliba says the group's core portfolio includes defensive stocks such as Woolworths, delivering the goods year after year, and Westpac, which he regards as the most low-risk, well-managed bank. But the core portfolio also includes medium-term tilts towards sectors with the potential to beat the overall market.

For example, BHP-Billiton is riding a wave of strong demand from China and emerging nations, booming commodity prices and the prospect of a further boost in demand as the global economy recovers. BHP is now trading at a price-earning ratio of 19.5 times forecast 2010 earnings, which Saliba regards as fair value considering the high level of growth expected in the years ahead.

Similarly, Saliba thinks Fairfax, publisher of *The Sydney Morning Herald*

and *The Age*, is well placed to benefit from the improving economy and an increase in job ads.

"Fairfax has underperformed the broader market in recent times but the cyclical nature of the stock makes it a good candidate to hold through the first few years of the economic cycle," he says.

Brambles is another cyclical stock that has been punished by a market concerned about its Chep pallet business in the US.

Saliba says the company has made efforts to address problems with the business and is well placed to profit from the upswing in the global economy as retail sales and the movement of

portfolio with a spread of companies across different industries and sizes, it boosts your chances of long-term success," D'Amato says.

At the smaller end of the market, he selects IT outsourcing firm ASG Group and Austin Engineering. Austin services the mining and resources industry with operations in Australia, South America and the Middle East.

Listed companies have begun reporting their results for the six months to December, making this an opportune time to put together a list of stocks to keep an eye on.

"For conservative investors, waiting for companies to report before committing your cash is a reasonable

'Waiting for companies to report before committing your cash is a reasonable strategy.' Elio D'Amato, Lincoln chief executive

goods increases and drives demand for pallets.

"We recommend good-quality stocks, including some that offer a flavour of the times, that provide opportunity and security at the same time," Saliba says.

COMPANY RESULTS

Long-term investors should not dismiss small companies in their search for safety or they will miss out on the next Google, Microsoft or Berkshire Hathaway, the investment company Buffett founded more than 40 years ago.

Small, well-managed companies with products and services that are in demand have a higher growth profile than larger companies. The trick is to assess the sustainability of the company's earnings with a steely eye and avoid being carried away by hype about blue sky and new paradigms.

"If you pick a quality, diversified

strategy," D'Amato says. Not only do companies release their financial results but directors often comment on trading conditions and the outlook for the year ahead.

Patterson says Argo has not bought any stocks this year and declines to offer picks but confirms he is watching the current reporting season for opportunities.

The market tends to punish companies if their results are disappointing. If the selling is overdone and the price of otherwise solid companies is marked down too far, then this presents a potential bargain.

Patterson singles out Worley Parsons, a provider of engineering services to the resources sector. Worley downgraded its earnings guidance on January 13 and its price dropped from just above \$30 to below \$24. "It was harshly treated by the market but it's on our list to consider," Patterson says.



Montgomery says Woolworths and The Reject Shop follow a similar model and all three have little or no debt and the strong cash flow necessary to pay down debt quickly.

D'Amato also likes "category killers" and plumps for Woolworths, CSL and Coca-Cola Amatil.

Like Woolworths in retail, CSL has firmly established itself as a leader in biopharmaceuticals, a sector with excellent long-term growth prospects. And Coca-Cola dominates the Australian market for beverages by keeping pace with changing consumer preferences. It has added water, juice and food to its carbonated products and is expanding into Asia to ensure future growth.

DIVERSIFICATION

Like Buffett, listed investment company Argo Investments is a good example of patience paying off. But whereas Buffett buys whole companies he likes and holds on to them for the long haul, Argo aims to buy shares in a diverse portfolio of well-managed companies that offer safe, steady long-term growth.

Argo has been investing in Australian listed companies since 1946. Over the past 20 years, it has achieved compound growth of 12.4 per cent a

STOCKS FOR STAYERS

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|  Roger Montgomery Value Investor |  John Price Conscious Investor |  Elio D'Amato Lincoln |  Paul Saliba Lachlan Partners |
| JB Hi-Fi | Billabong | Woolworths | BHP-Billiton |
| CSL | Cochlear | CSL | Westpac |
| Cochlear | ARB | Coca-Cola Amatil | Woolworths |
| Commonwealth Bank | Fleetwood | ASG Group | Fairfax |
| McMillan Shakespeare | Wridgways | Austen Engineering | Brambles |