the Investors' Voice

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Features

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AUSTRALIAN INVESTORS ASSOCIATION

How to buy the best stocks

By Roger Montgomery

Last year Alan Kohler asked me to write about a portfolio. So I put one together, bought a few stocks and started writing. To cut a long story short, the stocks selected positively whipped the market return and I traded only three times in the year. Common sense, it seems, is not all that common; but I'd like to share some with you.

Few investors bother to look properly for the best companies, because they see reading annual reports as too difficult (or too boring); but I have no doubt in my mind that you are already more than qualified to do it.

The first thing you need to do is turn the stock market off. The reality is that it doesn't contribute as much to your returns as you might think. In fact there's a real risk that it has become an unnecessary crutch and is slowing you down. All of those prices, up-to-the-second quotations, daily announcements, research reports and opinions serve their purveyors much better than they serve you. So turn them and your computer off. As Warren Buffett, the world's most successful investor, has demonstrated, you may not need a computer at all.

Instead, use what you already know. Make no mistake, your own energy and intellect hold the key to finding value in the stock market. In the quiet that now confronts you, you can think.

The next step is to separate the extraordinary businesses from the ordinary ones. Identify those that have superb economics, outstanding prospects for sales, profits and intrinsic value, and peerless management. As you are about to discover, winnowing the good from the ordinary is easier than you might think.

Let's consider a basic investment option for $100,000 — a term deposit. A quick search on Andrew Willink's website (ratecity.com.au) will show that the latest interest rates being offered for term deposits vary between 5.5% and 6.5%. How long did it take for you to decide that 6.5% term deposit offers the highest return and is therefore significantly better value than the others? Not long, because it was easy to put all accounts on a level playing field for comparison purposes and see which is going to give you the highest return.

Approach the selection of businesses the same way, and you will have no problem identifying extraordinary businesses that offer better value than the ordinary ones.

Your goal as an investor is to have your money work as hard for you as you did for it. Think of the cash you have in your bank account, or the investments in your super fund. What return do you want from those assets? I'm guessing as high a return as possible, with a correspondingly small outlay. That's almost as much as you need to know. All that remains is to find the right numbers being reported by a company, which can help you compare options and reach rational conclusions.

Take a look at two businesses The first is JB Hi-Fi, which earns $94m after tax; the second is Primary Health Care, which earns $107m after tax. Their profits suggest Primary is the bigger and therefore superior company. But is it? In which one would you invest $100,000?

If you said Primary Healthcare, simply because it earns more, you would be making a decision with insufficient information. In business, owners regularly look at how much money they're making; but in reaching conclusions about how good their business is, they invariably have at least one eye on how much money they can put back into the business. They inevitably compare what is coming out to what they are investing. When looking at Primary and JB Hi-Fi, unlike the business owner, you haven't yet considered how much capital is required to generate those profits. To do this you too must start thinking like a business owner. As CEO, your job is to get the highest returns. To do that you must put in as little capital as possible to generate each dollar of profit. Start thinking like this and you'll have no problem identifying the superior businesses.

What if I told you that it would require $2.1b for Primary to generate the $107m in after-tax profits — equivalent to a mere 5% return on the equity you've put in? What about JB Hi-Fi? To generate a similar profit of $94m after tax, the company needs just $230.2m. The profit therefore represents a 40.8% return on the money you've invested in the business. Looking at companies this way is no different to comparing term deposits. Which one would you choose now?

It will take only a few seconds for you to determine that you would rather own all of JB Hi-Fi than even a small piece of Primary Healthcare. Indeed, if you could invest the same $2.1b into JB Hi-Fi and the company continued generating the same 40.8% return on equity, net profit after tax would amount to $862.1m. The best businesses, the really extraordinary ones, are those that generate more value each year. And the best filter for finding those is return on equity — the return you would be entitled to if you owned the whole business. Even Buffett agrees. In 1997 he said:

> Except for special cases (for example, companies with unusual debt–equity ratios or those with important assets carried at unrealistic balance sheet values), we believe [a more appropriate measure] of managerial economic performance to be return on equity capital.

Before you rush off and buy high-return-on-equity businesses, consider one more thing. The final step in your assessment must be to value the business, ensuring that the price you pay is a bargain one. You can't go and pay any price, even for the best businesses. A great asset purchased at a high price can become a very poor investment.

Valuation is a separate course, and while it's not that complicated, I don't have the space to write about it here. It requires a few chapters — which, I'm happy to report, you will find in the first edition of my first (and probably only) book, *Value.able*.

Once you've established a conservative valuation for the company and its shares, you can turn the stock market back on and see whether anyone is offering to do anything silly.

In an urgent world that drives you to act constantly, such an approach seems boring or even slothful, but it is precisely this single-minded focus on the best businesses that will almost always improve your investment returns.

Roger Montgomery is the author of the book Value.able, which is available via his website, www.rogermontgomery.com.

Bulletin board

AIA Conference 2011

At the time of publication the AIA 2010 Investors Conference will have been held at the Surfers Paradise Marriott Resort. After receiving feedback from members the Council of the AIA have decided to hold their 2011 conference in Sydney. Details will be forwarded to members once the venue and dates have been confirmed. However, the likely month will be September 2011.

Member Discounts

The AIA offers a range of member discounts which can all be viewed on the AIA website www.investors.asn.au. Go to ABOUT THE AIA / MEMBER DISCOUNTS. Great discounts are offered for online subscriptions, investment books, software and more.

50% Pension Relief Extended

As you are probably aware, the Government has announced that the 50% reduction of minimum pension amounts will continue for another year, until 30 June 2011. This is certainly good news for many pensioners, 50% less withdrawn, but keeping 100% tax exemption.